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RESTORING FISCAL BALANCE IN CANADA

# FOCUSING ON PRIORITIES



CANADA'S NEW GOVERNMENT

TURNING A NEW LEAF

BUDGET 2006

May 2, 2006

Canada



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BUDGET 2006



Department of Finance  
Canada

Ministère des Finances  
Canada





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# 1

## INTRODUCTION









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***"This new government will take a new approach. It is committed to building a better federation in which governments come together to help Canadians realize their potential. To this end, the Government will respond to concerns about the fiscal imbalance and will work to ensure fiscal arrangements in which all governments have access to the resources they need to meet their responsibilities."***

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Speech from the Throne  
April 4, 2006

Cooperation and collaboration between the Government of Canada and the provinces and territories have been critical to the development of the Canadian federation. Federal, provincial, territorial and municipal governments, working together, have created a network of programs covering health, education, social services, infrastructure, justice and a range of economic and social policies designed both to improve the quality of life of Canadians and to enhance the economic performance of the country.

Fiscal arrangements underpin the relationship between governments. They support the achievement of shared national objectives, reduce interprovincial disparities and provide territories with funding in recognition of the unique challenges of Canada's North.

Debates over fiscal arrangements in Canada are not new. As discussed in Annex 1, many of the debates of the past focused on challenges that continue to this day—especially the need to continually adapt to changes in fiscal balance that result from evolving circumstances and the changes in the roles and responsibilities of governments that accompany them.

Key issues of past debates—the need to address fiscal disparities among provinces and territories; the need for accountability and transparency, as well as clarity in roles and responsibilities; the need for tax harmonization and other forms of intergovernmental collaboration—also continue to resonate today. In addition, new issues have arisen in recent years, including how to deal with substantial unplanned federal surpluses and the challenges facing municipalities.



### Major Concerns

Chapters 2 to 5 set out four major sets of concerns that are the focus of the current debate:

- Chapter 2 describes how large, unplanned federal surpluses have given rise to concerns that federal budgeting has not been sufficiently transparent.
- Chapter 3 describes how the federal government, since recording surpluses, has undertaken significant new spending initiatives in areas of provincial responsibility—while it has neglected some of its core areas of responsibility—leading to concerns about blurred accountability and reduced clarity with respect to roles and responsibilities of each order of government.
- Chapter 4 describes how the federal government cut transfers to provinces and territories in order to get its fiscal house in order in the mid-1990s, and then made significant investments that restored overall transfers. But concerns remain that some transfers have not yet been put on a principle-based, predictable, long-term track. Controversy also surrounds the use of federal transfers to address specific regional needs.
- Chapter 5 describes the need for both orders of government—separately and working together—to do more to enhance the efficiency and competitiveness of the economic union.



## The New Approach

Chapter 6 sets out the Government's approach for following through on the commitment made in the Speech from the Throne on April 4, 2006, to address concerns over the fiscal imbalance. The Government's approach is based on five principles:

- Accountability through clarity of roles and responsibilities.
- Fiscal responsibility and budget transparency.
- Predictable, long-term fiscal arrangements.
- A competitive and efficient economic union.
- Effective collaborative management of the federation.

Consistent with these five principles, the new government is proposing immediate actions in Budget 2006, and is committing to further action in the coming year after discussions with provinces and territories.

The Government is also proposing to consult Canadians, provinces and territories, academics and other stakeholders on additional ideas for further improving fiscal relations in Canada.

## Moving Ahead

Chapter 7 lays out a process of consultations to follow through on the Government's commitment to restore fiscal balance in Canada.



# 2

## CONCERNS OVER TRANSPARENCY IN FEDERAL FISCAL PLANNING









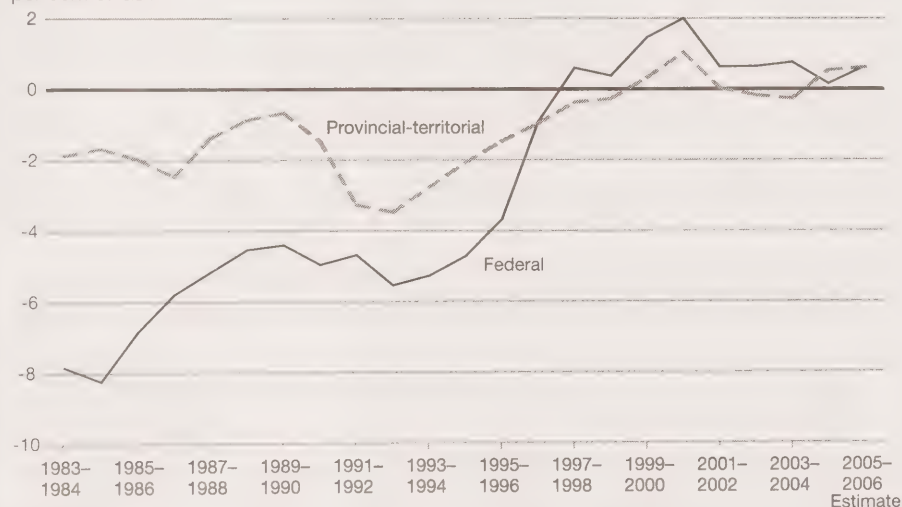
Prior to the late 1990s, both orders of government went through a sustained period of running fiscal deficits, resulting in rising debt-to-GDP ratios. The deficits were clearly unsustainable, and both orders of government significantly reduced program spending in order to bring their respective finances under control. (Annex 2 describes in greater detail the evolution of the federal and provincial-territorial fiscal situation in recent decades.)

Several provinces led the way to a return to sound public finances. The federal government was able to record its first surplus in 1997–98 and has since had eight consecutive years of surplus. Progress toward balanced budgets proceeded at a different pace in different provinces and territories: they achieved a combined positive budgetary balance in 1999–2000 and posted combined positive budgetary balances in five of the past seven years.

Chart 2.1

## Federal and Provincial-Territorial Fiscal Situations Have Improved Significantly Since the Mid-1990s

per cent of GDP



Sources: Federal, provincial and territorial Public Accounts and budgets.



## Benefits From Sound Finances

There is strong agreement that this return to sound finances has generated many benefits for Canada and Canadians:

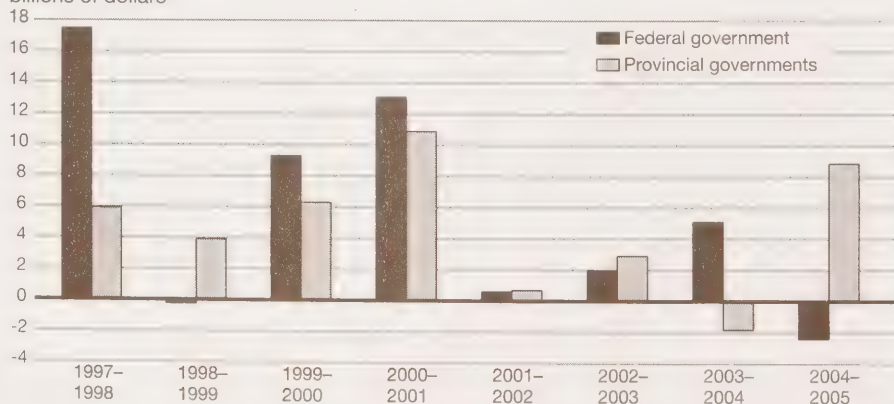
- It has allowed governments to reduce their debt and, combined with strong economic growth, has resulted in a reduction in debt-to-GDP ratios. The federal debt-to-GDP ratio fell from a peak of 68.4 per cent in 1995–96 to 38.3 per cent in 2004–05. Provincial and territorial government debt ratios also declined—albeit unevenly across provinces and territories and not as dramatically overall as for the federal government—to an aggregate debt-to-GDP ratio of 22 per cent.
- It has allowed both orders of government to cut taxes.
- It will help governments prepare for the fiscal consequences of population aging, which will result in increased expenditures on such things as elderly benefits and health, and slower revenue growth, as the labour force begins to shrink.

While the restoration of Canada's fiscal health has been a positive development, federal surpluses over the last eight years have generally been larger than anticipated, generating considerable controversy. On average, the federal budgetary balance has been \$5.6 billion better than forecast in the budget each year since 1997–98. Over the same period, aggregate provincial budgetary balances also exceeded their forecast by \$4.7 billion a year on average.

Chart 2.2

### Both Federal and Provincial Governments Have Registered Larger Than Expected Budgetary Balances in Recent Years

billions of dollars



Note: Amounts calculated based on the differences between actual budgetary balances and the one-year ahead budget forecast.

Sources: Federal and provincial Public Accounts.



### Reasons for Larger Than Anticipated Surpluses

An independent review of the federal government's fiscal forecasting process in 2005 by the International Monetary Fund (IMF) found that Canadian federal budget projections of macroeconomic and fiscal aggregates have been more cautious than those in other countries since the mid-1990s, resulting in a consistent underestimating of budget balances and the largest average forecast errors among the countries examined.

There are two reasons why these better than expected results have occurred:

- **The strength of the Canadian economy:** The Canadian economy has repeatedly exceeded the expectations of private sector economists, whose forecasts are used in the federal budget-making process. In this respect, the IMF noted that “stronger-than-expected growth appears to account for a considerable part of the fiscal overperformance.”
- **A prudent approach to fiscal forecasting:** The federal government adopted a high degree of prudence in its fiscal planning to meet the firm commitment of achieving a balanced budget or better in every single year in the face of significant economic and fiscal uncertainty. This approach reflected the concern that the credibility of federal budgeting needed to be re-established in the financial markets, so it was imperative to build a track record of budget surpluses. The IMF concluded: “a conservative budgeting approach constitutes a rational response to a regime where the costs of missing a fiscal target are both high and asymmetric, as has been the case in Canada over the past ten years.”

### Concerns Over Larger Than Projected Surpluses

The repetition of much larger than projected surpluses has led to three recurring criticisms of federal budgeting from participants in the current debate over fiscal relations:

- There are perceptions that the federal government has not been as transparent as it could have been with Parliament, Canadians and other orders of government—the amount of prudence effectively incorporated in budget planning was larger than the announced public guidelines to ensure balanced budgets.



- A significant portion of the federal surpluses was also unplanned, resulting in large, last-minute, year-end spending that was not always guided by a pre-announced policy framework. This reduced the scope for parliamentarians and Canadians to have an informed debate on how these fiscal dividends were allocated.
- Most prominently, large federal surpluses were used in part to spend in areas of primarily provincial responsibility, which has led many to believe that the federal government has more than enough fiscal capacity to meet its spending requirements, particularly in comparison to provinces and territories, which continue to face considerable spending pressures.



# 3

## CONCERNS OVER BLURRED ACCOUNTABILITY DUE TO REDUCED CLARITY IN ROLES AND RESPONSIBILITIES







## **Legislative Roles and Responsibilities**

The Constitution assigns a range of exclusive legislative powers to the federal and provincial orders of government. It also explicitly provides for joint federal and provincial jurisdiction over contributory public pensions (such as the Canada Pension Plan), agriculture and immigration.

## **Taxation**

The Constitution also explicitly sets out federal and provincial taxation powers. While both orders of government are given fairly general tax powers, provincial taxation powers are formally restricted to direct taxation. In practice, this constraint has had only a limited impact on provinces' ability to access major tax fields because most major taxes in use today are direct taxes, such as personal and corporate income taxes and payroll taxes. Constitutional jurisprudence has also confirmed that sales taxes levied by provinces are direct taxes as well. Provinces, therefore, have access to all major tax fields in use today.

## **The Spending Power**

By contrast, unlike most constitutions adopted by federal countries since the early 20th century, Canada's Constitution does not explicitly provide for a general spending power. Over time, it has become common in practice for both orders of government to spend in areas over which they do not exercise legislative jurisdiction. Transfer payments from the federal government to provinces and territories in support of programs such as health care, post-secondary education, training, housing or child care constitute prime examples.

## **Shared Responsibilities in Certain Areas Can Result in Less Clarity**

In practice, the multi-faceted nature of many policy issues and the emergence of entirely new areas of public policy since the 1860s have resulted in pragmatic arrangements that have contributed to a lack of clarity in roles and responsibilities in certain areas.

There are distinct federal and provincial aspects to many areas, such as the environment, where responsibility for key policy instruments falls to both orders of government. In such cases, federal and provincial-territorial governments have needed to work out how to coordinate their distinct but related responsibilities in the best interests of Canadians.



### Current Roles and Responsibilities in Canada

	Federal	Provincial
Money and banking	✓	
International and interprovincial trade	✓	
Airlines and railways	✓	
Telecommunications and broadcasting	✓	
Foreign affairs/international assistance	✓	
Defence and veterans affairs	✓	
Border security	✓	
Employment insurance	✓	
Criminal law	✓	
Fiscal Equalization	✓	
Indirect taxation	✓	
Direct taxation	✓	✓
Pensions and income support	✓	✓
Aboriginal peoples	✓	✓
Immigration	✓	✓
Agriculture	✓	✓
Industry	✓	✓
Environment	✓	✓
Policing	✓	✓
Transportation infrastructure	✓	✓
Housing	✓	✓
Post-secondary education, training and research	✓	✓
Public health	✓	✓
Primary and secondary education		✓
Health care		✓
Municipal institutions		✓
Social assistance and social services		✓
Natural resources		✓
Administration of justice		✓



In efforts to eliminate its deficits during the early and mid-1990s, the federal government considerably reduced program spending both in areas of clear federal responsibility and on transfers supporting areas of primarily provincial and territorial responsibility. Once balanced budgets were restored, and particularly once the federal government began to register significant surpluses, it was able to launch new spending initiatives. But the pattern of new spending that emerged during the past decade has often led to concerns about blurred accountability.

## Insufficient Focus on Federal Responsibilities

During the period of budgetary restraint in the mid-1990s, the federal government reduced its spending on core areas of federal responsibility. In some areas, the gaps that resulted have not been closed after eight years of surpluses and rapid increases to overall federal program spending. In other cases, the federal government injected new funds, but without changes in focus that would be required to make federal spending more effective at meeting its goals and adapting to new realities. Examples include:

- **Defence:** The progressive erosion of the federal commitment to national defence since the 1960s was aggravated by significant cuts made to Canada's defence programs in the mid-1990s. Even with increases in recent budgets, significant pressures remain for further investments to enhance security, defend Canada's sovereignty over its vast territory and territorial waters, and maintain Canada's long-standing international military role.
- **Border Security:** Despite significant investments following the tragic events of September 11, 2001 and in light of threats posed by pandemics, significant pressures remain to do more to improve Canada's national security and to work with the United States on facilitating the movement of people and goods while controlling risks along our shared border.
- **Coast Guard:** Since 1987, the Canadian Coast Guard has not purchased any new large vessels and has been operating and fulfilling its mandate with an aging civilian fleet. It was only in 2005 that significant new funds were allocated towards acquiring new vessels.
- **Immigration:** Despite significant investments, pressures remain to manage immigration backlogs and a complex refugee determination system. Canada must attract the highly skilled and talented newcomers it needs to meet its economic challenges and be able to promptly remove those individuals who do not have a legitimate right to remain in the country.





- **Justice and Law Enforcement:** There remain significant pressures for increased investments and new approaches in the criminal justice system and law enforcement to ensure that federal interventions are adequate and effective at providing security at home as well as at Canada's borders and internationally.
- **International Assistance:** While commitments have been made for significant increases in Official Development Assistance (ODA), greater attention needs to be paid to ensuring that this assistance is as effective as possible.
- **Aboriginal People:** Substantial resources have been provided for Aboriginal people since the deficit was eliminated. Despite this, significant pressures remain for further investments and for increased accountability, and to ensure these investments become more effective at addressing the needs of Aboriginal communities for adequate water, schools, housing and other services.

## Use of the Federal Spending Power in Areas of Provincial Responsibility

In parallel to this insufficient focus on priorities in areas of federal responsibility, various initiatives—which have expanded the use of the federal spending power—have been launched in areas of provincial responsibility since the federal deficit was eliminated. Concerns have been raised that these initiatives have often imposed new conditions and cost pressures on provincial and territorial governments. Examples include:

- **Early Childhood Development:** In September 2000, \$2.2 billion over five years in new funding was announced for transfers to provinces and territories—conditional upon expansion of early childhood development programs and services.
- **Child Care:** In 2003 more than \$1 billion over five years was committed for provinces and territories—conditional upon expansion of their regulated child care programs and services. Budget 2005 announced a further \$5 billion over five years—conditional upon development of government-regulated child care across the country.
- **Housing and Homelessness:** Starting in 1999, \$1.3 billion in funding for efforts to target homelessness was announced. Since 2001, a further \$1 billion has been put in place to increase the supply of affordable rental housing, which was made available to provinces and territories on the condition that they match federal contributions.



While these initiatives have provided welcome support for Canadians, they and other examples of increased federal spending in areas of primarily provincial responsibility often:

- Resulted in strains between the federal government and the provinces and territories in cases where expenditures were undertaken without adequate consultation or consensus on priorities.
- Created new cost pressures on provincial and territorial governments, potentially distorting their spending priorities, particularly where initiatives required matching funds.
- Increased uncertainty where initiatives were introduced without long-term, stable federal funding.

The combined effect of increased federal spending in areas of provincial responsibility, and a lack of focus on areas of clear federal responsibility, has been to raise concerns over increasingly blurred lines of accountability that make it more difficult for Canadians to determine which order of government should be held accountable for specific policies and initiatives.



# 4

## CONCERNS OVER PREDICTABLE, LONG-TERM FUNDING FOR FISCAL ARRANGEMENTS









Fiscal arrangements underpin federal support for less prosperous provinces and territories, for shared national priorities and for federal efforts to address specific needs with a regional focus.

Subsection 36(2) of the Constitution Act, 1982 commits the federal government “to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.” This commitment is met through the Equalization program. The Government is also committed to this principle in respect of territorial governments who receive funding through Territorial Formula Financing (TFF), taking into account the unique needs in the North.

There is also a clear consensus among Canadians on the importance of support for health care, post-secondary education and training, and infrastructure. Federal and provincial-territorial governments must continue to work together on these shared priorities to ensure that Canadians have:

- Access to timely quality health care regardless of their ability to pay.
- Affordable, accessible and high-quality post-secondary education and training that is responsive to the needs of the labour market and supports an innovative economy through a world-class research capacity.
- Modern, well-functioning infrastructure across the country.

There are also circumstances that require the federal government to address unique circumstances, such as natural disasters, where its support must be targeted to the specific needs of a province, territory or region of the country. This federal role is critical to the functioning of the federation, because it ensures support for all parts of the country in times of need.

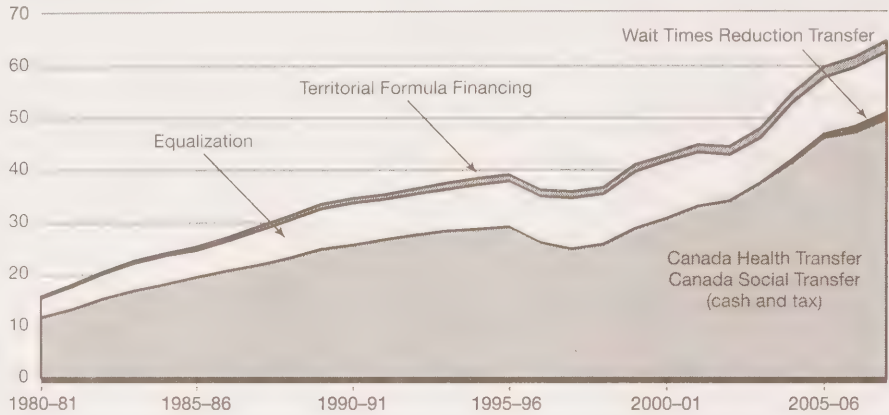
There have always been debates about the Equalization and TFF programs, the appropriate level of the federal contributions to shared priorities, and targeted federal spending to address regional needs. Over the past decade, concerns have been raised that the stability, predictability and fairness of these transfers were being compromised. While overall transfer levels have been restored, concerns remain that not all transfers have been put on a principle-based, long-term, predictable funding track.



Chart 4.1

### Major Transfers Have Largely Been Put Back on a Long-Term Funding Track, Though Concerns Remain in Some Areas

billions of dollars



Note: Wait Times Reduction Transfer funding of \$5.5 billion is included as part of the 2004 10-Year Plan to Strengthen Health Care.

Source: Department of Finance Canada.

The remainder of this chapter examines, in turn, federal support for:

- Equalization and Territorial Formula Financing.
- Health care.
- Post-secondary education and training.
- Infrastructure.
- Targeted funding for specific regional needs.

Annex 3 provides additional background information on the workings and evolution of major fiscal transfers.



## Equalization and Territorial Formula Financing (TFF)

### Concerns Over a Loss of Direction in Equalization

In recognition of the fact that provinces have varying levels of fiscal capacity, or ability to raise revenues, the federal government provides Equalization payments to less prosperous provinces, so that all provincial governments are in a position to provide reasonably comparable services at reasonably comparable tax rates.

Unlike other major transfers, Equalization was not cut as part of the fiscal restraint measures of the mid-1990s, and the five-province standard, which had been part of the Equalization formula since 1982, was maintained.

In recent years, the operation of that formula nevertheless generated a sharp decline in Equalization payments, from a peak of \$10.9 billion in 2000–01 to \$8.8 billion in 2003–04—reflecting the combined impact of a reduction in fiscal disparities, tax reductions in several provinces, and a series of data revisions.

This decline in Equalization created concerns about the predictability and stability of payments—an issue that has become increasingly important for provinces as they attempt to maintain annual balanced budgets. The lower payments also raised concerns that the declines largely offset—for Equalization-receiving provinces—the positive effects of increased federal support for provincial health spending.

The decline in Equalization also generated renewed debate on three long-standing issues that have important implications for the size of Equalization payments and their distribution among Equalization-receiving provinces:

- **The standard to which the fiscal capacities of provinces should be raised:** Most provinces have called for a return to the 10-province standard used prior to 1982, arguing that the five-province standard was not capturing the growing importance of Alberta's revenues.
- **The treatment of natural resource revenues in the program:** Views differ widely on this issue, from arguments that resource revenues should not be included in the measurement of fiscal capacity—because, for example, Equalization effectively offsets the financial benefits of resource ownership and does not take into account provincial expenditures required to develop natural resources—to arguments that all revenues need to be counted to accurately measure a province's fiscal capacity.



- **The measurement of other tax bases:** Provinces have argued that the measurement of fiscal capacity for some tax bases needs to be improved. For example, there is general agreement that the existing measure of fiscal capacity for property taxes should be revised.

### **Concerns Over the Adequacy of Territorial Formula Financing**

Concerns have also been expressed about the adequacy of Territorial Formula Financing. While the territories do not receive Equalization, they receive significant federal support through TFF.

Prior to 2004, the program was based on a formula that calculated the difference between an expenditure “base” and eligible revenues in each territory. This “gap-filling” approach to territorial funding recognized the unique circumstances facing territorial governments and the higher costs of providing public services in the North.

TFF was subject to a ceiling between 1988–89 and 2001–02 that limited growth in TFF grants from 1990–91 to 1993–94. The 1995 budget also imposed restraint on TFF with a 5-per-cent cut to each territory’s Gross Expenditure Base—the proxy for territories’ expenditure requirements in TFF. Subsequent growth in the program was based on these lower Gross Expenditure Bases.

Since this cut, territorial governments have been consistent in calling for restoration of funding. Territorial governments believe that their funding was subject to greater restraint measures than Equalization, and that TFF does not adequately fund their expenditure requirements.

### **October 2004 Changes to Equalization and TFF**

In the wake of these concerns, a new framework for Equalization and TFF was put in place in October 2004, following the September 2004 health funding discussions among First Ministers. A key aspect of this new framework is that total payments for Equalization were increased by \$2.0 billion to \$10.9 billion in 2005–06. TFF was increased by \$0.2 billion to \$2.0 billion. These amounts were then legislated to grow at 3.5 per cent annually up to 2013–14. Establishing fixed amounts for these programs represented a marked departure from the long-standing approach of having overall payments determined each year by a formula.





In tandem with the introduction of the new framework, an Expert Panel on Equalization and Territorial Formula Financing was established to publicly review many aspects of the two programs. (The terms of reference of the Expert Panel are summarized in Annex 1.)

Since the results of the Expert Panel's work would not be available for payments in 2005–06, a temporary formula for allocating the aggregate Equalization and TFF funding amounts among provinces and territories was adopted.

Most provinces, territories and the majority of academic experts in fiscal federalism have been critical of the move to a “fixed envelope” approach to these programs, arguing that the size of the programs would no longer automatically respond to changes in fiscal disparities.

The report of the Expert Panel on Equalization and Territorial Formula Financing will be released in spring 2006. This and other recently released reports including the report of the Council of the Federation Advisory Panel on Fiscal Imbalance, along with subsequent consultations with provinces and territories, will be critical elements in arriving at renewed, principle-based Equalization and Territorial Formula Financing programs.

## **Concerns Over Delays in Restoring Federal Support for Health Care**

Federal, provincial and territorial governments have long shared the common goal of providing Canadians with high-quality health care. In addition to its own responsibilities in the area of health care, the federal government supports provinces and territories in the provision of health care through fiscal arrangements. Federal transfers support the Government of Canada's commitment to maintain the five criteria of the Canada Health Act (comprehensiveness, universality, portability, accessibility and public administration), and the provisions discouraging extra billing and user fees.

## **Reductions in Federal Support**

As part of overall fiscal consolidation, the federal government announced in Budget 1995 a 30-per-cent cut to its \$18.7 billion in cash transfers supporting provincial and territorial health, post-secondary education, and social assistance and social services; it also restructured its funding into a single transfer called the Canada Health and Social Transfer (CHST).



These transfer cuts—amounting to \$6 billion a year—were criticized as a unilateral offloading of the federal deficit onto provinces and territories. Pressure to restore transfers—and to put them back on a predictable long-term track—intensified once the federal government’s fiscal position began to improve.

### **Pressures to Increase Funding for Health Care**

At roughly the same time, concerns began to emerge about the sustainability of the public health care system in Canada. Provinces and territories experienced mounting fiscal pressures due to rising health care costs, which began to crowd out other spending priorities. An aging population and the need for reinvestments after many years of restraint were also putting pressure on the health care system.

Widespread consensus emerged on the need for reform of the publicly funded health care system and new investments to support such reform. The federal government responded slowly by first stabilizing cash transfers in the late 1990s and then increasing them several times through the CHST. These increases were largely directed at health care support, including the 2000 Agreements on Health Renewal and Early Childhood Development, which provided more than \$23 billion over five years to provinces and territories.

### **Growing Concerns Over the Sustainability of the Health Care System**

While transfers were being restored, the question remained whether the federal contribution was adequate, particularly in the wake of continuing rapid cost increases. In addition, the issue of the sustainability of the public health care system was being questioned, particularly since provincial health spending was growing at 7 per cent or more annually. A number of provinces commissioned major reports on health system performance, reform and health care funding. The federal government, for its part, established the Commission on the Future of Health Care in Canada (The Romanow Commission), which consulted widely with Canadians, stakeholders and governments. (See Annex 1 for further details.)





In February 2003, following the release of the Romanow Report, First Ministers reached a new Accord on Health Care Renewal, which provided increased federal funding of almost \$37 billion over five years in transfers and federal direct spending targeted to health. The CHST was restructured to create a separate Canada Health Transfer (CHT) and a Canada Social Transfer (CST) effective April 1, 2004, in order to increase transparency and accountability as recommended by the Romanow Commission.

While significant new investments were provided in support of the 2003 Accord, funding levels did not meet the financial benchmarks established by the Romanow Report. Pressure therefore continued on the federal government to close what became known as the “Romanow gap” in transfers.

## **Long-Term Predictable Funding**

First Ministers met again in September 2004 to find a long-term solution to health care funding. Building on the earlier federal-provincial agreements and reports, First Ministers for the first time signed an agreement on health care reform, known as the 10-Year Plan to Strengthen Health Care. Federal cash transfers for health were increased by a total of \$41 billion over 10 years. The CHT was increased to \$19 billion in 2005–06 and an automatic annual escalator of 6 per cent was legislated.

The 6-per-cent annual escalator is higher than the projected growth in nominal gross domestic product (GDP) and reflects a reasonable estimate of the projected rate of growth in underlying health costs over the medium term. As noted below, the escalator means that federal support for health care will increase each and every year—about \$1.1 billion in new funding in 2006–07, an additional \$1.2 billion on top of that in 2007–08, and growing larger amounts each year for the balance of the Accord.

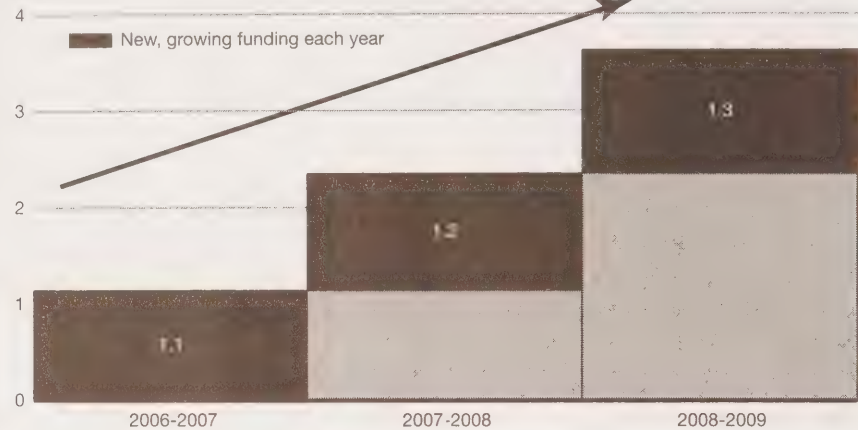
Beyond the CHT, the 10-Year Plan also provided targeted funding for medical equipment and long-term funding for wait times reduction. The funding attached to the Plan met and exceeded the benchmarks set out by the Romanow Report.



Chart 4.2

## Impact of 6-Per-Cent Escalator for CHT

billions of dollars



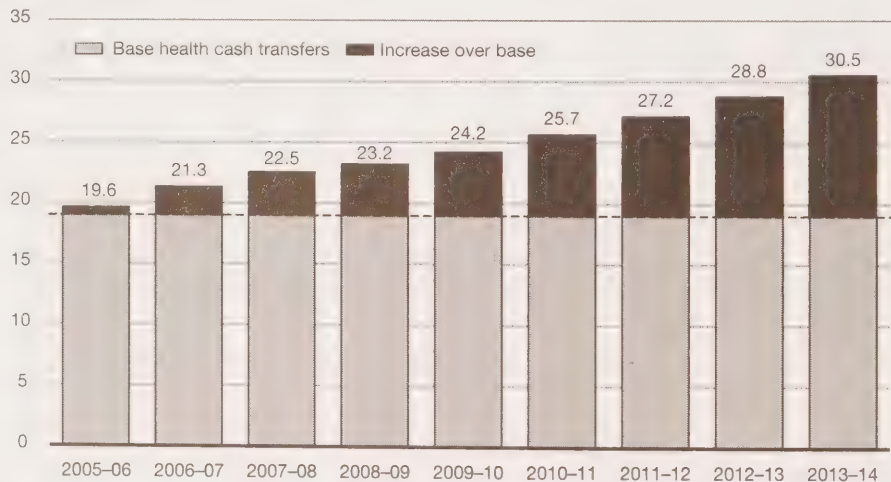
Note: Health transfers, set at \$19 billion in 2005-06, will grow by \$1.1 billion in 2006-07 as a result of the 6-per-cent annual escalator, an additional \$1.2 billion on top of that in 2007-08, and growing to larger amounts each year throughout the life of the 10-Year Plan. By the last year of the 10-Year Plan, 2013-14, the escalator will provide an additional \$1.7 billion on top of the 2012-13 level.

Source: Department of Finance Canada.

Chart 4.3

## Federal Health Transfers Have Now Been Put Back on a Predictable, Long-Term Growth Track

billions of dollars



Source: Department of Finance Canada.



## **The Shifting Focus of the Debate**

Both orders of government have increased their financial support for health care well in excess of the growth of nominal GDP for a number of years. The federal government was able to commit to further growth of 6-per-cent a year over the life of the 10-year agreement because of the fiscal dividends associated with a declining debt burden.

Given the contributions by both orders of government, the focus of concerns regarding the future of health care is now turning from the respective contribution of each order of government to the implementation of the 10-Year Plan, and in particular to achieving measurable progress on reform and wait times reduction while ensuring that health care spending is managed efficiently. Cost increases that continuously exceed the growth of government revenues will eventually require governments to resort to tax increases, a move that could undermine Canada's competitiveness.

Governments must work together to achieve the health system reforms identified in the 10-Year Plan, including reductions in wait times, primary care and home care reform and expanded catastrophic drug coverage, and to meet the targets identified in the 2004 Accord with respect to improved public reporting.

## **Concerns Over a New Mix in Federal Support for Post-Secondary Education**

The federal government is a long-standing contributor to post-secondary education (PSE) in Canada. The system of universities and colleges that exists today reflects decades of collaboration and cooperation between the two orders of government.

As with health care, the federal government provides substantial support for post-secondary education through transfers to provinces and territories. These transfers traditionally accounted for a significant proportion of federal support for post-secondary education, with the balance taking the form of direct support for students and research at universities.

As in the case of transfer support for health care and social programs, federal transfers for post-secondary education were also affected by the 30-per-cent cut in cash transfers announced in the 1995 budget.



Once the federal deficit was eliminated, transfer support to the CHST and its successor program, the Canada Social Transfer (CST), for post-secondary education and other social programs was increased—although most of the transfer increases in recent years were directed to health care. Recent federal investments in post-secondary education have been targeted to direct support for research at post-secondary education institutions, student financial assistance and training initiatives.

### **Increased Federal Support for Research**

Canada's overall investments in research as a share of the economy placed it in the middle ranks of Organisation for Economic Co-operation and Development (OECD) nations in the mid-1990s. Universities were facing reduced research budgets and a lack of adequate research infrastructure.

Since the deficit was eliminated, the federal government has increased its support for post-secondary education research, with nearly \$11 billion in incremental funding. These investments have assisted Canadian universities in strengthening their research capacity and building a global reputation for excellence, which has helped reverse the “brain drain” and attract leading researchers to Canada. Canada now ranks first in the G7, and second in the OECD (behind only Sweden) in terms of research and development performed in the post-secondary sector as a share of the economy.



## Increased Funding for University-Based Research Provided in Previous Budgets

	1998– 1999	1999– 2000	2000– 2001	2001– 2002	2002– 2003	2003– 2004	2004– 2005	2005– 2006	2006– 2007
	(millions of dollars)								
Canada Foundation for Innovation <sup>1</sup>	30	115	185	230	325	350	265	430	430
Genome Canada <sup>1</sup>				43	60	85	82	90	85
Canada Research Chairs			60	120	180	240	300	300	300
Canada Graduate Scholarships						25	55	85	105
Medical Research Council of Canada/Canadian Institutes of Health Research	40	72	145	255	330	385	424	456	456
Natural Sciences and Engineering Research Council of Canada	71	111	118	118	154	209	248	281	283
Social Sciences and Humanities Research Council of Canada	9	26	38	58	67	82	94	108	88
Indirect costs of research				200	nil	225	245	260	260
Networks of Centres of Excellence		30	30	30	30	30	30	35	35
Tri-University Meson Facility	15	15	21	21	21	21	21	25	26
<b>Total (annual)</b>	<b>165</b>	<b>369</b>	<b>597</b>	<b>1,075</b>	<b>1,167</b>	<b>1,652</b>	<b>1,764</b>	<b>2,070</b>	<b>2,068</b>
<b>Total (cumulative)</b>	<b>165</b>	<b>534</b>	<b>1,131</b>	<b>2,206</b>	<b>3,373</b>	<b>5,025</b>	<b>6,789</b>	<b>8,859</b>	<b>10,927</b>

<sup>1</sup> Amounts shown represent actual or anticipated spending flowing from the \$3.65 billion invested in the Canada Foundation for Innovation, and \$600 million provided to Genome Canada by the Government through previous budgets.

Source: Department of Finance Canada.





### **Increased Direct Federal Support to Students**

In addition to providing increased support for research and human capital, new federal investments in post-secondary education have focused increasingly on direct support and tax measures to students and their families. In 1995–96, approximately \$2 billion in direct support measures for post-secondary education was provided. By 2004–05, this direct support had grown to approximately \$5 billion.

Federal direct support to post-secondary education students totals about \$3.5 billion annually, including Canada Student Loans to some 330,000 students; non-repayable student financial assistance through the Canada Study Grants and Canada Access Grants; and measures to help students and families save for future education, including the Canada Learning Bond and the Canada Education Savings Grant. Over \$1.5 billion in tax relief is also provided to help offset the costs of pursuing higher education, through measures such as the Tuition and Education Amount credits, and the Student Loan Interest Credit.

This increased direct support has helped Canada achieve the highest level of post-secondary education attainment among OECD countries: 43 per cent of Canada's population aged 25-64 has some post-secondary education. For younger Canadians (25-34), this proportion increases to 51 per cent, again the highest in the OECD.

### **Change in the Mix of Federal Support for Post-Secondary Education**

While the total share of federal support has remained relatively constant over time (at about 25 per cent of overall expenditures by post-secondary education institutions), the mix of federal instruments has changed. Today, a larger proportion of support is provided through direct measures than through transfers to provinces and territories. Federal cash transfers for post-secondary education—an estimated \$2 billion of the CST—have declined as a share of total post-secondary education expenditures.

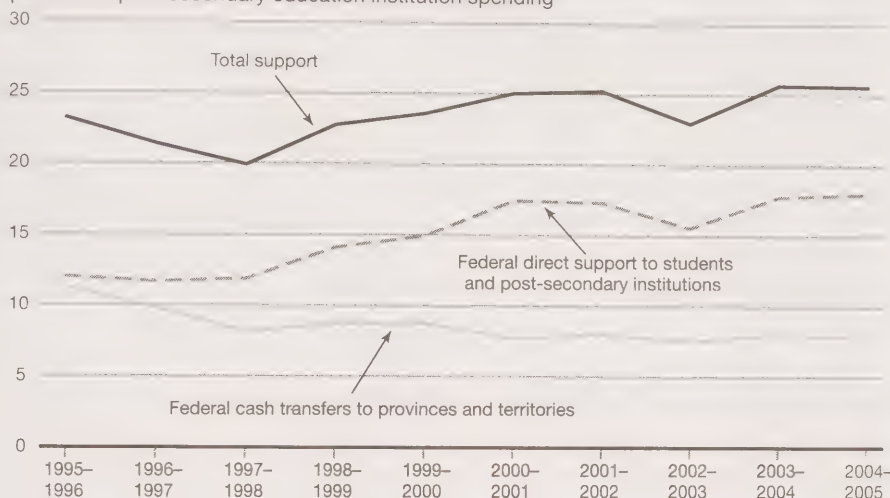




Chart 4.4

### Total Federal Support for Post-Secondary Education Has Been Relatively Constant Since the Mid-1990s

per cent of post-secondary education institution spending



Source: Department of Finance Canada.

## Pressures on Post-Secondary Education and Training

During the 1990s, provinces also reduced their direct support for post-secondary education, resulting in an increased reliance of post-secondary education institutions on tuition fees. This change in the level and mix of support is now raising concerns over the need for renewed investments, necessitated in large part by increasing demand for post-secondary education.

As a result, there has been growing concern over the need for additional transfer support to provinces and territories for post-secondary education. Stakeholders have also pressed for a separate post-secondary education transfer to be created to enhance transparency of the federal contribution.

In addition, while progress has clearly been made in building a well-educated and innovative work force within Canada, gaps remain, and greater attention needs to be given to the full range of learning and training opportunities. Technological change is altering the level of skills required in many work environments, yet Canada currently has a lower rate of workplace training investment by firms and individuals than many of our competitors.



Another important gap is in our support for the trades: young Canadians are often not encouraged enough to consider the trades, or unable to access this type of training because of financial barriers.

### **Concerns Over Federal Support for Infrastructure**

Canada's quality of life and economic competitiveness depend in part on having reliable, efficient infrastructure that is provided in large part by the municipal, provincial, territorial and federal governments. For example, a world-class transportation network is required for businesses to bring goods to market, both within Canada and abroad, and to meet the travel needs of urban and rural Canadians. Also, Canadians deserve and expect a high standard of basic services, such as clean and safe water to drink.

### **A Decline in Infrastructure Investments**

While comparatively large infrastructure investments were made in the 1950s and 1960s, spending by all orders of government on public infrastructure as a proportion of GDP declined over the subsequent three decades.

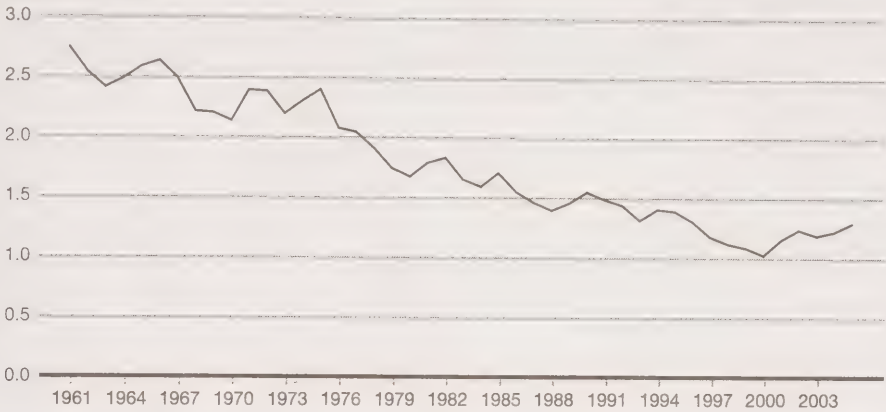
While these declines in infrastructure investment were not unique to Canada, the country's infrastructure has been showing signs of stress, risking tangible adverse economic and social impacts. For example, there have been instances where the deteriorating quality and insufficient capacity of public infrastructure, such as roads and water systems, has had a direct impact on the quality of life of Canadians and Canada's ability to attract and retain businesses. As the state of their public infrastructure declined, Canadians had to endure longer commutes due to gridlocked highways. As well, continued rapid growth in trade has created congestion at Canada's "gateways"—including major border crossings—constraining the country's ability to increase its trade with the rest of the world.



Chart 4.5

**Investment in Public Infrastructure  
Has Been Declining as a Percentage of GDP**

per cent of GDP



Note: Infrastructure is defined as fixed non-residential building and engineering construction of federal, provincial, territorial and local public administrations.

Source: Department of Finance Canada.

## A Rebound in Infrastructure Investments

After the fiscal restraint of the mid-1990s, investment in infrastructure has begun to rebound. But it is clear that larger, ongoing investments in Canada's infrastructure will be needed to build a stronger economic union, take advantage of opportunities abroad and enhance quality of life. The federal government, provinces and territories, cities and other communities each have important roles to play in this regard.

The federal government has historically invested heavily in infrastructure that falls under its areas of responsibility. This includes railways, marine facilities (e.g. ports and the St. Lawrence Seaway), airports and the air navigation system. Much of this infrastructure has been commercialized or privatized over the past two decades. This has resulted in better approaches to managing these assets and has promoted investments in line with users' needs.



### **Increased Federal Support in Recent Years**

Provinces, territories, cities and other communities are also responsible for major elements of Canada's infrastructure, including highways and local roads, water and sewage systems, and urban transit. The federal government has provided these governments with financial assistance to help them meet their infrastructure responsibilities. This level of support has fluctuated over time, but has increased significantly in recent years.

Much of this support is being delivered through federal infrastructure programs:

- The Canada Strategic Infrastructure Fund targets large-scale infrastructure projects such as highway improvements, transit expansions and urban development.
- The Border Infrastructure Fund targets infrastructure improvements to land crossings (e.g. better access roads).
- The Municipal Rural Infrastructure Fund provides assistance to municipal infrastructure projects, particularly in small and rural communities.

A number of trade facilitation and security measures have also been put in place to ensure the seamless and secure movement of people and goods across the Canada–U.S. border, but additional investments will be required.

### **New Federal Support for Cities and Communities**

Federal initiatives support cities and communities, which play a vital role in creating and maintaining well-functioning infrastructure:

- Full relief of the goods and services tax (GST) and the federal portion of the harmonized sales tax (HST) paid by municipalities was legislated in 2004, and will deliver approximately \$2.7 billion to municipal budgets over the next four years to help fund critical infrastructure priorities.
- In 2005, the federal government also committed to share a portion of the revenues of the federal gasoline excise tax to support municipal infrastructure. Between 2005–06 and 2009–10, this commitment will provide \$5 billion in new revenue for municipalities.





Taken together, these federal investments in infrastructure are significant, but this funding needs to be put on a long-term track to allow for long-term planning, especially given the time spans involved in planning and building major infrastructure projects. Municipal governments are notably calling for a commitment from the federal government to continue its funding support for municipal infrastructure projects. There is also pressure for additional funding to provinces and territories for transportation infrastructure, particularly the National Highway System.

To ensure that Canadians get value for their governments' investments in infrastructure, there is also a need to ensure greater transparency and accountability in relation to those investments—including a need for clarity in respective roles and responsibilities of all governments, as well as active collaboration and coordination of their investments.

## **Concerns Over Funding Arrangements Targeted to Address Specific Regional Needs**

The confidence of Canadians in the overall fairness of federal programs has been undermined in recent years as the result of federal actions that were seen to be departing from the principle of comparable treatment of all Canadians and their provincial and territorial governments. In particular:

- The February 2005 agreements to provide Nova Scotia and Newfoundland and Labrador additional fiscal Equalization offset payments sought to address the severe fiscal challenges faced by those two provinces as a result of their high public debt, but were widely criticized as undermining the principles on which the Equalization program is based.
- Delays by the previous federal government in concluding a Labour Market Development Agreement with Ontario and shortfalls in federal support for immigration settlement in Ontario (which receives the largest number of Canada's immigrants) and some other jurisdictions were also widely criticized as constituting inequitable treatment of provinces. When the federal government finally took action in 2005 it did so through a bilateral fiscal agreement that went beyond the long-standing concerns of the Government of Ontario in these areas.

These actions were seen as a departure from the norm for federal programs: federal tax policies, direct programs and funding of shared priorities through transfers to provinces and territories are typically Canada-wide in nature and seek to address the needs of Canadians on as comparable a basis as possible in all parts of the country.



### Targeting Federal Assistance on Needs

By their nature, the federal government's Canada-wide programs focus on providing comparable support to Canadians. These programs inevitably result in some degree of inter-regional distribution between more prosperous and less prosperous provinces or regions. For example, the federal government raises more tax revenue in more prosperous provinces, and uniform Old Age Security pensions flow disproportionately to provinces with more elderly and low-income residents.

Comparability does not mean uniformity. The federal government is, like provincial governments, committed by subsection 36(1) of the Constitution Act, 1982 to “promoting equal opportunities for the well-being of Canadians,” “furthering economic development to reduce disparity in opportunities” and “providing essential public services of reasonable quality to all Canadians.” To address the sometimes very different situations of Canadians living in different parts of the country, federal support must sometimes be tailored specifically to those needs, often in collaboration with provincial and territorial governments.

In the case of federal financial support for shared priorities in areas of provincial responsibility—where needs are Canada-wide—the approach has been to make transfers to all provincial and territorial governments to enable them to tailor their programs to local variations in needs and priorities.

In other cases, federal programs target needs that are not Canada-wide in scope, but concentrated in particular regions or at particular times. For example:

- In responding to natural disasters and other emergencies—such as the floods in the Saguenay in 1996 and Manitoba in 1997, the 1998 ice storm, and the BSE (bovine spongiform encephalopathy) and SARS (severe acute respiratory syndrome) crises—the federal government collaborates with provincial and territorial governments to provide an “insurance policy” to all Canadians.
- Federal support to meet the challenges currently facing Canadian agriculture in collaboration with provincial governments flows mostly to provinces with important agricultural sectors, just as federal support for fisheries flows to coastal provinces.



# 5

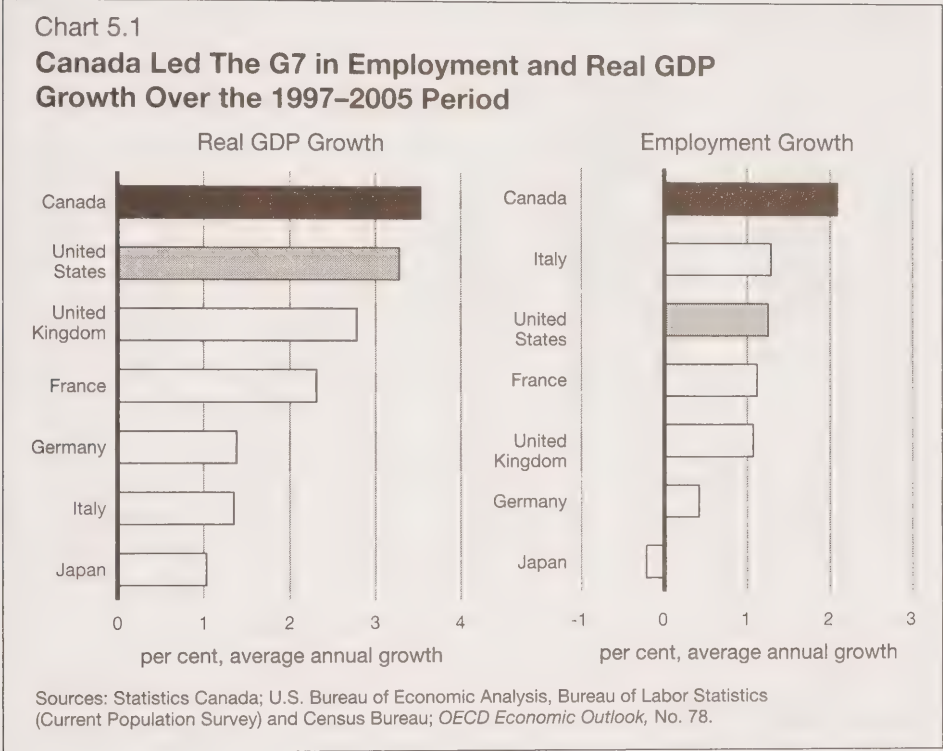
## CONCERNS OVER A COMPETITIVE AND EFFICIENT ECONOMIC UNION







In recent years, strong global growth and rising demand for Canadian commodities, combined with provincial and federal policies to improve the flexibility and adaptability of the economy, have helped generate solid gross domestic product (GDP) growth and healthy gains in employment.



As the population ages, Canada will be less able to rely on gains in the share of the population that is working for future growth in living standards. Indeed, the employment-to-population ratio is projected to decline as the baby boom generation retires. Instead, Canada must increasingly rely on productivity growth to increase our standard of living.

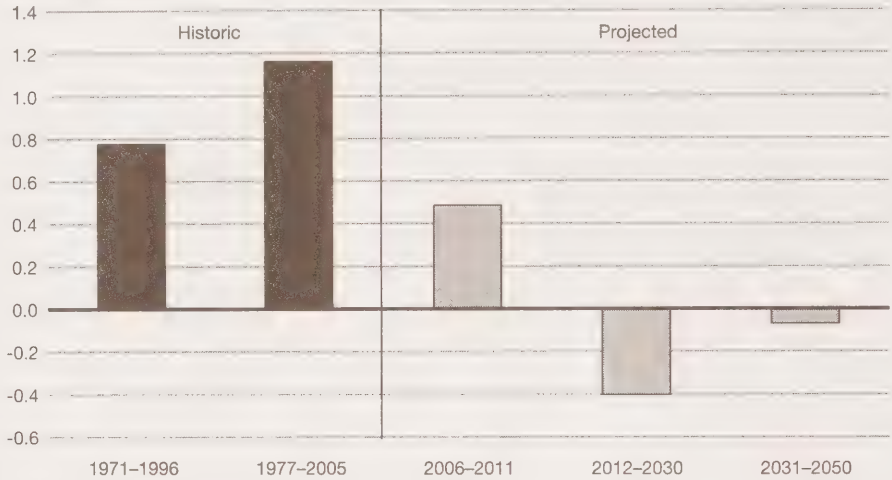


Chart 5.2

### Productivity Growth Will Be Required in the Future to Offset Projected Declines in the Size of the Labour Force

(Growth in Employment-to-Population Ratio)

per cent, average annual growth



Source: Department of Finance Canada calculations.

In addition to the challenges posed by demographics, Canada must also prepare for the opportunities and increased competition of fast-growing economies, and the widespread adoption of new ways of producing and delivering goods and services around the world. In many respects, barriers to trade and to mobility are being eliminated more rapidly outside our borders than within them.

Each order of government must therefore contribute to creating an environment that allows the private sector to generate the wealth necessary to foster shared goals of job creation and high living standards, while maintaining a sustainable environment and high-quality public services. Doing so will also mean reducing taxes for all Canadians so that they have more money to make choices about what to buy, when to save, and where to invest to allow our economy to grow to its full potential. It will also require more effective regulation across a range of goods and services, labour and capital markets issues.

To strengthen the economic union, governments will have to work together better, especially with respect to mobility and trade, employment for immigrants, capital markets and tax harmonization.



## **Barriers to Mobility and Trade Within Canada**

While some progress has been made on reducing barriers to trade within Canada, primarily through the Agreement on Internal Trade (AIT), a number of barriers still exist that unnecessarily limit growth, investment and job creation.

For example, greater progress could be made to reduce impediments to the mobility of skilled labour between provinces. A recent, extensive survey commissioned by all governments revealed that when a professional trained in Canada moves from one province to another, the destination province does not recognize the professional qualifications of the originating province one-third of the time. This means that Canadians often cannot find the best jobs that are available to them, and employers cannot choose the most qualified workers. This is especially important now, given the labour shortages experienced regionally and sectorally.

Other areas where more progress is possible include the conclusion of the Energy chapter of the AIT, which would give a province the right to transmit electricity through another to a third market (“wheeling”) and greater regulatory harmonization across jurisdictions to simplify transactions for businesses.

## **Barriers to Employment for Immigrants**

Immigration not only enriches Canada’s diversity, it also bolsters our labour force and prosperity. Immigration is an important source of labour force growth and is expected to account for all of the net growth in Canada’s population within the next ten years, if current trends continue.

While more than 50 per cent of recent immigrants have some post-secondary education or trade certification, the challenge lies in ensuring that the immigration system meets the needs of the economy and that this inflow of new, skilled, talented individuals can quickly integrate into the workforce and the community.

Many immigrants have difficulty entering the professions and careers in which they were trained and engaged in their country of origin. The federal government, provinces and professional regulatory bodies have crucial roles to play in recognizing foreign credentials.



### **Barriers to Efficient Capital Markets**

An important foundation for a strong economy is a regulatory regime for the securities market that ensures market integrity and investor protection. Efficient capital markets promote domestic and foreign investment in the economy, stimulating productivity growth and jobs. All jurisdictions recognize that Canada's securities regulatory system must be improved to respond more rapidly and effectively to regulatory and market developments at home and abroad.

The provinces and territories have made progress in improving the current system of securities regulation in Canada by narrowing regulatory differences and streamlining the administration of securities laws. To maximize benefits for investors and issuers and strengthen the federation, intensified efforts are required.

### **Benefits From Further Tax Harmonization**

A key to maintaining an efficient tax system that provides governments with the flexibility to raise the revenues they need is to harmonize taxes to the greatest degree possible.

Canada has achieved a substantial degree of tax harmonization without compromising policy flexibility. The recently revised and signed Tax Collection Agreements, which promote a common tax base and a single administrator for both corporate and personal income taxation, illustrate how efficiency and flexibility can be combined. These agreements help to reduce compliance costs for taxpayers and administration costs for governments. Even in the case of provinces that have not entered into such agreements (such as Quebec in the case of both personal and corporate income taxes, and Ontario and Alberta in the case of corporate income taxes), a significant degree of harmonization in the definition of the tax base has been maintained.

Recent efforts by federal and provincial governments to phase out capital taxes have also been a major step in enhancing the efficiency of the tax system, as these taxes have particularly negative impacts on investment and distort the allocation of capital within Canada.





But there remain areas where additional harmonization would provide substantial benefits. On tax collection, the Government is working with Ontario to extend the Tax Collection Agreements to include Ontario's corporate income tax.

More importantly, work needs to be done on the sales tax front. Harmonized value-added taxes are now in place in Newfoundland and Labrador, Nova Scotia and New Brunswick—and Quebec administers a provincial value-added tax, as well as collecting the goods and services tax on behalf of the federal government. But separate provincial retail sales taxes continue to be collected in five provinces, increasing administration and compliance costs for both governments and businesses. Provincial retail sales taxes also substantially increase the effective tax rate on investment by taxing business capital goods and intermediate materials, thereby impairing the competitiveness of our tax system.



# 6

## THE GOVERNMENT'S APPROACH







The previous chapters describe the key issues regarding fiscal relations in Canada today.

This chapter sets out the Government's approach for meeting those challenges and the principles that will guide it. It is a multi-pronged approach, designed to ensure a return to balanced fiscal arrangements in which all governments have access to the resources they need to meet their responsibilities.

In particular, the Government is committed to a renewed relationship with provincial and territorial governments, based on collaboration in restoring fiscal balance and supporting the provision of quality services to Canadians—including areas of shared priority such as health, post-secondary education and infrastructure.

To that end, fiscal arrangements and intergovernmental collaboration and coordination mechanisms—the instruments that form the backbone of fiscal relations among governments—must be guided by principles that reflect Canada's values and traditions and the challenges facing the country.

The Government is committed to a comprehensive solution to the challenge of restoring fiscal balance in Canada, guided by the following five principles discussed in detail below:

- Accountability through clarity of roles and responsibilities.
- Fiscal responsibility and budget transparency.
- Predictable long-term fiscal arrangements.
- A competitive and efficient economic union.
- Effective collaborative management of the federation.

The Government believes the actions set out in this chapter encompass the most urgent and important concrete steps that need to be taken to restore and maintain fiscal balance in Canada. The Government also acknowledges that maintaining that balance will be an ongoing joint responsibility of both federal and provincial-territorial governments and that evolving circumstances may, in the future, warrant further adjustments.

To that end, the Government is also proposing discussions with Canadians, provinces and territories, academics and other stakeholders on a number of additional ideas for improving fiscal balance that may merit future consideration.





## Accountability Through Clarity in Roles and Responsibilities

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***The Government of Canada is committed to the principle of enhancing the accountability of governments through clarification of their respective roles and responsibilities.***

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Governments need to be accountable to Canadians for their taxing and spending decisions. Clarity of roles and responsibilities is essential to ensuring that Canadians can hold governments accountable for their actions.

First and foremost, this requires ongoing respect for local autonomy and diversity and for the roles and responsibilities that other orders of government are best placed to perform, whether by virtue of their exclusive constitutional jurisdiction or because they have a comparative advantage in the delivery of programs and policies in particular areas.

In keeping with the Social Union Framework Agreement (SUFA) signed by the federal government and all provinces other than Quebec in 1999, the Government of Canada will limit the use of the federal spending power in areas of provincial responsibility to ensure that:

- New shared-cost programs in areas of provincial responsibility have the consent of the majority of provinces to proceed.
- Provinces and territories have the right to opt out of shared-cost federal programs with compensation if they offer similar programs with comparable accountability structures.

Accountability and clarity of roles and responsibility require that each order of government has access to the revenues required to fulfil its roles and responsibilities.



For the federal government, this means raising the revenues needed to fulfil its responsibilities in relation to maintaining sound federal finances, including ongoing repayment of the federal debt; ensuring the efficient functioning of the national economy; and implementing sound policies in the areas of defence, foreign policy, security, Status Indians on reserve, Equalization, Territorial Formula Financing (TFF), and financial support of shared priorities through transfers to provinces and territories.

This also requires that excess federal revenues be used primarily to reduce federal taxes rather than to launch new policies in areas where the federal government is not best placed to design or deliver programs.

Ensuring clarity and an appropriate matching of revenues to expenditure responsibilities for both orders of government enables Canadians to better hold their governments to account, thereby ensuring appropriate tax burdens and best “value for money” in the public services funded through those taxes. In addition:

- This should reduce intergovernmental frictions that stand in the way of providing quality services to Canadians, including federal services that reflect Canada-wide needs and priorities, and provincial and territorial services that reflect needs and priorities that vary from one part of Canada to another.
- Respecting provincial and territorial autonomy in the areas for which they are responsible should also facilitate policy experimentation and the development of new policies that can better meet the needs of Canadians in all parts of the country.

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***The Government of Canada is proposing  
immediate action to enhance accountability  
by clarifying roles and responsibilities.***

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The Government is proposing immediate action to refocus federal efforts on supporting families with children by providing Canadians with greater choice in child care through direct transfers to families with children. Parents will be able to choose the child care option that best suits their family needs—whether that means formal child care, informal child care through neighbours or relatives, or a parent staying at home.



This proposal reflects recognition that the federal government is better placed to provide income support to families with children, and that provinces and territories are better placed to tailor child care services and support to the wide variety of needs among Canadian families. The Government's child care proposal builds on the improved support to families with children that resulted from clarification of federal and provincial-territorial responsibilities as part of the 1998 National Child Benefit (NCB) (described below).

The Government will also take immediate action to refocus federal efforts toward the reforms and funding that are required to meet long-standing needs in core areas of federal responsibility, including:

- Investments in national defence.
- Enhancement of border security and emergency preparedness.
- Investments in national policing.
- Investments in immigration settlement.
- Investments for Aboriginal people.
- A more robust diplomatic role for Canada and a more effective use of Canadian aid dollars.

The Government is also proposing major reductions to the federal tax burden through an immediate 1 point reduction in the goods and services tax (GST) to 6 per cent and additional personal income tax cuts.



## **Realignment of Roles and Responsibilities: The National Child Benefit Model**

Following discussions in the 1990s, the federal government and provinces and territories agreed on an approach for developing the National Child Benefit initiative.<sup>1</sup>

The NCB initiative, launched in 1998, is a joint approach under which the federal, provincial and territorial governments act together to reduce child poverty while lowering the “welfare wall” that discourages many parents on social assistance from taking a job because they may lose child-related benefits and services.

The NCB initiative has proven to be an innovative and progressive approach for investing in children. It integrates federal, provincial and territorial systems of income support for children into a national platform of income-tested child benefits available to families on social assistance and low-income working families.

Under the NCB initiative, the NCB supplement has replaced an increasing proportion of child-related basic income support provided under social assistance. Resulting provincial-territorial social assistance savings have been redirected to new or enhanced benefits and services for low-income families with children. Examples of provincial reinvestments include earned income supplements, child care subsidies and supplementary health coverage.

<sup>1</sup> The Government of Quebec chose not to participate in the NCB because it wanted to assume control over income support for children in Quebec but has stated that it agrees with the basic principles of the NCB and has adopted a similar approach to the NCB.

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### ***The Government of Canada is proposing to discuss ideas on how to further clarify federal and provincial-territorial roles and responsibilities.***

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In addition to its specific commitment to early action for refocusing federal efforts toward policies and programs it is best placed to deliver, the Government is also proposing to discuss ideas for further clarification of roles and responsibilities through realignments in federal and provincial expenditures in other areas. Particular focus could be given to areas, such as housing, where both federal and provincial-territorial governments provide similar kinds of support and especially those where current arrangements may generate fiscal pressures on provinces and territories and distort their spending priorities.



# Fiscal Responsibility and Budget Transparency

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***The Government of Canada is committed  
to the principle of ongoing fiscal responsibility  
and transparent budget planning.***

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Fiscal responsibility is essential for governments to be able to provide quality services on a sustainable basis and to ensure intergenerational equity. Maintaining a fiscally responsible approach to budgeting, including a commitment to ongoing debt reduction, is especially important given the demographic challenges facing Canada—an aging workforce and low birth rate—and the resulting future pressures on health, publicly funded pensions, immigration and other social programs. The Government's commitment to ongoing debt reduction also reflects the fact that while the federal debt-to-GDP ratio has declined significantly, it is still much higher than that of the provinces and territories.

Transparent fiscal planning rests on accurate, timely and complete information and analysis: these are fundamental to understanding a nation's finances. Just as important, informed public debate on setting fiscal and budgetary priorities for the federal government further requires a high degree of public transparency in relation to that information.

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***The Government of Canada is proposing  
immediate action to restore transparency to  
budget planning and ensure ongoing  
fiscal responsibility.***

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The Government is proposing immediate action to implement:

- A new Federal Accountability Act, including a Parliamentary Budget Officer.
- A new approach to budget planning.
- Actions to limit spending growth and better manage expenditures.
- A commitment to reducing the federal debt.
- Reforms to the Government's financial reporting.





These actions will enable Canadians to openly debate national fiscal and budgetary priorities, based on a clear understanding of the federal government's true fiscal position.

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***The Government of Canada is proposing  
discussions on mechanisms for directing the use  
of unplanned surpluses at fiscal year-end.***

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Budget transparency could be further enhanced through adoption of clear rules or mechanisms for directing unplanned surpluses. Such rules or mechanisms would give parliamentarians and Canadians an opportunity to have a say on the most appropriate possible uses for unplanned surpluses, rather than leaving such decisions to be taken in haste by the government of the day (in the weeks preceding the end of the fiscal year) or by default (through the further reductions in federal debt that automatically result when unanticipated fiscal manoeuvring room is not used to increase federal spending).

Accordingly, the Government is proposing to discuss ideas for appropriate rules or mechanisms to allocate unplanned surpluses, with a particular focus on the idea of allocating a portion of unplanned surpluses in excess of \$3 billion a year to top up the existing investment funds of the Canada Pension Plan and Quebec Pension Plan (CPP/QPP). This idea is discussed more fully below.



### **Mechanisms for Allocating Unplanned Surpluses: An Approach for Discussion**

The Canada Pension Plan and Quebec Pension Plan are models of successful federal-provincial cooperation in an area of joint jurisdiction. They constitute a key pillar of Canada's retirement income system, with most of Canada's seniors counting on them for an important part of their income.

In the 1990s, the CPP and QPP faced a significant financial challenge, with large unfunded liabilities that made the Plan unattractive for new participants and put their financial sustainability at risk. After extensive public consultations, the federal and provincial governments—as joint stewards of the CPP—agreed to major reforms in 1997 that restored the long-term financial health of the Plan. Similar changes were also made to the QPP by the Government of Quebec.

The 1997 reforms also improved intergenerational fairness by pre-funding a larger proportion of future benefits, thereby reducing the extent to which younger and future generations are required to finance the benefits accruing to the generations currently in (or approaching) retirement.

Today, international economic organizations point to the CPP/QPP as examples of “best practices” in the area of retirement income security. Both the CPP and QPP are on track to achieve a significant degree of pre-funding (unlike public pension plans in most other countries, which continue to operate largely on a “pay-as-you-go” basis) and are acknowledged to be fiscally sustainable for at least the next 75 years.

Nevertheless, the fairness of the CPP and QPP could be further improved. While the 1997 reform agreement helped address some of the intergenerational unfairness that had built up in the CPP, current young workers will still have to pay a much higher contribution rate (9.9 per cent) than that paid by past generations for the same benefits, in order to make up for the fact that the contribution rate was unsustainably low for many years. For example, a young Canadian born in 1990 will earn a real rate of return of 2.1 per cent on his or her CPP investment, compared to a rate of return of 6.2 per cent for someone born in 1940. By committing to direct a portion of federal unplanned surpluses to the CPP/QPP, the Government could help to lower the future contribution rates and thus improve intergenerational equity in the Plan. For example, each \$5 billion in unplanned surpluses directed to the CPP and QPP could generate an additional return to the Plans of \$350 million a year, assuming an average rate of return comparable to what the CPP Investment Board has earned since its inception.



To that end, the Minister of Finance will undertake consultations with provinces and territories on the merits of allocating a portion of unplanned federal surpluses to the CPP/QPP or of other rules or mechanisms that may be proposed.

## Predictable Long-Term Fiscal Arrangements

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***The Government of Canada is committed to the principle of ensuring long-term funding support for shared priorities and a transparent, principle-based approach to its transfers to provinces and territories.***

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Intergovernmental transfers are important tools to ensure that all governments have adequate revenues to meet their responsibilities. These transfers also help to ensure adequate support for shared priorities—such as health care and post-secondary education—that foster a strong economic and social union and equal opportunities for all Canadians.

Federal transfers for shared priorities need to support provinces and territories in their long-term policy planning and to allow them to remain accountable to their residents for the public services they provide and the taxes they raise to finance them. To do so, federal transfers need to be predictable and to grow in line with reasonable and fiscally sustainable projections of future expenditures in the areas supported by these transfers over the long term.

Federal transfers to provinces and territories, including support targeted on particular regional needs, also need to be based on transparent principles and formulas and to reflect decisions arrived at following open multilateral discussions between the federal government and all provincial and territorial governments.



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***The Government of Canada is proposing  
to take immediate action to lay the foundations for  
a return to predictable long-term fiscal arrangements  
in Canada within the coming year.***

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The Government is proposing immediate action to lay the foundations for a predictable and long-term system of fiscal arrangements by:

- Confirming its commitment to the 10-Year Plan to Strengthen Health Care and Patient Wait Times Guarantee for health care.
- Providing certainty with respect to Equalization and Territorial Formula Financing payments for 2006–07.
- Committing significant additional funding to support investments in infrastructure as well as maintaining commitments under the New Deal for Cities and Communities.

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***The Government of Canada is committed  
to further action over the coming year  
to put in place predictable and equitable  
fiscal arrangements for the long term.***

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The Government is also committed to taking further action over the coming year, following consultations with provinces and territories, to put in place long-term fiscal arrangements that will provide equitable and predictable support for:

- A transparent, principle-based Equalization program.
- Transparent, principle-based Territorial Formula Financing transfers that recognize the unique circumstances of the North.
- Post-secondary education and training.



Consultations on the restoration of transparent and principle-based Equalization and Territorial Formula Financing transfers will be guided by a number of key reports and recommendations from independent third parties, notably:

- The report of the independent Expert Panel on Equalization and Territorial Formula Financing will be released this spring. The Expert Panel was tasked with reviewing the two federal transfers and has undertaken public consultations across the country as well as in-depth consultations with provincial and territorial governments and academics.
- The recent report by the Council of the Federation Advisory Panel on Fiscal Imbalance, and a number of other recent reports prepared by other stakeholders, will provide valuable background to the Government's proposed consultations with provinces and territories.

Specifically, the Minister of Finance will undertake consultations with his provincial and territorial counterparts following release of the Expert Panel report, with a view to putting forward proposals by the fall of 2006 to provide provinces and territories with long-term certainty in relation to Equalization and TFF for 2007–08 and subsequent fiscal years.

In relation to post-secondary education and training, the Minister of Human Resources and Social Development will also undertake consultations with her provincial and territorial counterparts with a view to identifying appropriate roles and responsibilities for each order of government in support of post-secondary education and training. These consultations will serve as the basis for the development, within the next year, of proposals by the Government for long-term federal support for these priorities.

Fulfilling these commitments to further action will provide support for a sound, long-term foundation for key public services—in the areas of health care, post-secondary education, training and infrastructure—that Canadians see as shared priorities and will restore Canadians' confidence in the fairness and integrity of fiscal arrangements.





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***The Government of Canada is proposing to discuss ideas on how to further reinforce the predictability and fairness of fiscal arrangements in Canada on an ongoing basis.***

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The Government's commitment to restoring predictable, equitable and growing transfers that are based on clear principles will address the major concerns over the current fiscal imbalance in Canada and will restore Canadians' confidence in the overall fairness and integrity of fiscal arrangements.

As noted in Annex 1, there have been many calls over the years for structural realignments of tax policies that would have the effect of reducing or eliminating joint occupancy of particular tax fields, including the 2002 Séguin Commission report, which specifically suggested the federal government cease imposing the GST in exchange for the elimination of certain cash transfers.

Such proposals have been motivated by a number of different considerations, including increased accountability; greater clarity of roles and responsibilities; increased economic efficiency from reductions in compliance and administrative costs, etc. It has also been argued that increasing overall occupancy of tax fields by provinces and territories could result in a more predictable source of revenue than federal cash transfers.

At times during earlier fiscal relations debates, there were also proposals—some of which were implemented at various times during the 1960s and 1970s—for “tax transfers.” These tax transfers involved partial transfers of tax room from the federal to provincial-territorial governments, as a partial replacement for federal cash transfers or as part of broader federal-provincial agreements. In most cases, these tax transfers involved personal income taxes, but in some cases corporate income taxes and gaming revenues were also transferred to provinces and territories.



The Government acknowledges that maintaining fiscal balance and fairness will be an ongoing challenge and as part of its discussions, will consider ideas on how the predictability of funding arrangements can be maintained over the longer term. The Government will give particular attention to the implications of such ideas for:

- **Predictability and ongoing adequacy of revenues:** For example, whether increased access by provinces and territories to particular tax fields could lead, over time, to the re-emergence of either vertical and horizontal fiscal imbalances affecting particular jurisdictions or an entire order of government.
- **Fiscal responsibility and transparency:** For example, whether wholesale tax field realignments or tax transfers would materially increase budget transparency; whether loss of diversification in revenue sources by one or both orders of government would lead to increased volatility in revenues or inadequate access to revenue sources.
- **Accountability/clarity in roles and responsibilities:** For example, whether any tax transfers or changes made to the alignment of tax fields between governments would be consistent with the principle that tax changes should be made in a way that is transparent to taxpayers and enables them to hold governments accountable for changes in the taxes they raise.
- **Economic competitiveness and efficiency:** For example, whether full or partial loss of access to economically more efficient forms of taxation (such as broad-based consumption taxes) by governments as the result of tax field realignments might lead, over time, to an undue reliance on taxes that generate greater economic distortions.

The Government is also prepared to discuss ideas on how best to ensure that the level and distribution of its transfers to provinces will continue to be based on sound principles and to be seen as fair by Canadians in all parts of the country.



### **A Competitive and Efficient Canadian Economic Union**

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***The Government of Canada is committed to enhancing the competitiveness and efficiency of Canada's economic union.***

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To ensure growing living standards and enable Canadians to receive the quality public services they expect of their governments, the Government of Canada is committed to reducing or eliminating impediments to the competitiveness and efficiency of Canada's economic union—notably by refocusing federal policies on taxation and support for research and innovation and through coordinated or joint action with provinces and territories to remove other tax-related or regulatory impediments to productivity growth.

The Government's commitment to limit federal taxes to the levels required to raise the revenues needed to fulfill its responsibilities will also help promote competitiveness and efficiency by ensuring that overall taxes are not higher than required to meet the overall expenditure responsibilities of all governments.

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***The Government of Canada is proposing immediate action to promote greater competitiveness and efficiency through productivity growth.***

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The Government is proposing immediate action to implement:

- New tax measures to create jobs and spur economic growth.
- Comprehensive personal income tax relief.
- Additional tax measures for education and training.
- Investments that will ensure foreign-trained immigrants meet Canadian standards and contribute more quickly to the economy.
- Further initiatives to promote research and innovation.



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***The Government of Canada is committed to further action, in collaboration with provinces and territories, to address structural impediments to competitiveness and efficiency within Canada's economic union.***

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The Government will collaborate with provinces and territories on finding ways to address remaining impediments within Canada's economic union through coordinated or joint action:

- To reduce barriers to internal trade and labour mobility by collaboratively strengthening and following through on commitments in the Agreement on Internal Trade.
- Toward a common securities regulator that administers a single code, is responsive to regional needs, and has a governance structure that ensures broad provincial-territorial participation.
- To ensure close collaboration between a new foreign credentials recognition agency and provincial-territorial agencies responsible for professional accreditation, licensed trades and apprenticeships.
- To identify, in consultation with provinces and territories, potential measures to improve work incentives for low-income Canadians.

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***The Government of Canada is proposing to discuss ideas on how to further improve competitiveness and efficiency through coordinated changes in federal and provincial-territorial taxation policies, notably through increased tax harmonization.***

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The Government is proposing to discuss ideas for possible further coordinated action by federal, provincial and territorial governments to achieve greater harmonization of federal and provincial taxes, primarily by broadening or extending existing Tax Collection Agreements.



As discussed below, Canada's tax system, unlike those in most other federal countries, is characterized by the joint occupancy of major tax fields by federal and provincial-territorial governments and by a significant degree of tax harmonization under long-standing Tax Collection Agreements in several major tax fields. As a result, federal and provincial-territorial governments both enjoy a significant degree of fiscal autonomy while also minimizing tax compliance costs on Canadians and the administrative costs of tax collection.

But significant gaps in tax harmonization remain. Accordingly, the Government is willing to explore options for further harmonization in the interest of reducing compliance and administrative costs that stand in the way of increased competitiveness and efficiency. In particular:

- The Government will continue to pursue discussions already underway with Ontario with a view to the extension of federal-provincial Tax Collection Agreements to include Ontario's corporate income tax.
- The Government is also proposing to discuss ideas for further harmonization of sales taxes in Canada. Harmonized value-added taxes are already in place in Newfoundland and Labrador, Nova Scotia and New Brunswick—and Quebec administers a provincial value-added tax, as well as collecting the GST on behalf of the federal government. But separate provincial retail sales taxes continue to be collected in five provinces. These taxes result in inefficient and uncompetitive forms of taxation—notably the taxation of business inputs and exports—as well as increased administration and compliance costs for both business and government.





## **Building a Competitive and Efficient Tax System: Tax Harmonization and Tax Collection Agreements in Canada**

Unlike most other federal countries, both orders of government in Canada have access to all major sources of tax revenue and exercise substantial tax policy autonomy. As a result, most major tax fields are jointly occupied.

Joint occupancy of major tax fields offers significant benefits in terms of flexibility for each order of government to design tax systems that:

- Allow for equitable sharing of the tax burden.
- Provide a useful policy lever for economic development.
- Support stability of total revenues through a diversified portfolio of revenue sources.

On the other hand, joint occupancy potentially entails higher compliance costs for Canadians and administrative costs for governments. In the absence of measures to ensure coordination and cooperation, it can also lead to inefficient tax design and uncompetitive overall tax levels, as well as to a loss of government accountability.

In response, Canada has built a system that preserves the benefits of joint occupancy and minimizes its costs through harmonization of federal and provincial-territorial tax policies and Tax Collection Agreements—helping to promote economic efficiency and reduce administrative costs while preserving a high degree of fiscal autonomy for both orders of government.

## **Effective Collaborative Management of the Federation**

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***The Government of Canada is committed to ensuring effective collaborative management of key federal and provincial-territorial policies in areas where both orders of government will continue to play important ongoing roles.***

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Effective mechanisms for coordination and collaboration in federal and provincial-territorial policies are required in areas of joint jurisdiction—including the Canada Pension Plan, agriculture, immigration and the environment—to ensure that federal and provincial-territorial policies reinforce each other in the interests of Canadians, rather than working against each other.



The need for effective coordination and collaboration also carries over into areas of primarily federal responsibility, such as international relations, where:

- Federal actions can have important consequences for policies in areas of provincial-territorial responsibility, such as language and culture.
- Provincial cooperation is often required to ensure implementation of Canada's international obligations.

Similar forms of coordination are also required in relation to criminal law, where federal actions can have important consequences for provincial-territorial responsibilities in relation to the administration of justice.

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***The Government of Canada is proposing immediate action to extend effective collaborative management to new areas and to meet its responsibilities for effective collaborative management of matters requiring early joint decisions by federal and provincial-territorial governments.***

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The Government is proposing immediate action to:

- Create practical intergovernmental mechanisms to facilitate provincial participation in the development of the Canadian position in the negotiation of international agreements where provincial jurisdiction is affected, including an invitation to the Government of Quebec to play a role at the United Nations Educational, Scientific and Cultural Organization (UNESCO).
- Complete the triennial review of the Canada Pension Plan, in collaboration with the provinces.
- Provide additional support for Canadian farmers while developing a new policy framework in collaboration with the provinces.



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***The Government of Canada is committed to enhancing the effective collaborative management of other key federal and provincial-territorial policies.***

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The Government is committed to working with provinces and territories to enhance effective collaborative management of other key federal and provincial-territorial policies, including:

- A made-in-Canada climate change policy that is both viable and effective and that makes use of the suite of different legislative, regulatory and other tools available to the two orders of government.
- Improved coordination of federal and provincial policies in relation to criminal law and the administration of justice.
- Improved timeliness, certainty and predictability of environmental assessments for projects subject to both federal and provincial-territorial assessments.



# 7

## MOVING AHEAD







The Government is committed to restoring fiscal balance in Canada. This paper puts forward a new approach for more effective fiscal relations that will lead to a stronger Canada.

Budget 2006 outlines the immediate actions the Government is proposing to take.

## **Working to Strengthen the Federation— Budget 2006 Initiatives**

### **Accountability through clarity in roles and responsibilities of orders of government**

- Ensuring value for taxpayers' dollars through focus on federal responsibilities, spending discipline and tax reductions.
- Investments in core federal responsibilities:
  - Border security.
  - National Defence.
  - Emergency and pandemic preparedness.
  - Aboriginal people.
- Measures to protect Canadian families and communities, including significant investments in the RCMP.
- First 1-point reduction in GST rate.
- Universal Child Care Benefit.

### **Fiscal responsibility and transparency in budget planning**

- Federal Accountability Act, including a Parliamentary Budget Officer.
- Two-year budget planning horizon—introducing measures when affordable.
- Actions to limit spending growth and better manage expenditures.
- Planned annual debt reduction of \$3 billion and medium-term debt reduction target.
- Proposal for allocating unplanned federal surpluses.
- Reforms to the Government's financial reporting, including quarterly updates, consolidation of foundations and improved and transparent revenue and expenditure reporting.



### **Working to Strengthen the Federation— Budget 2006 Initiatives** *(cont'd)*

#### **Predictable long-term fiscal arrangements**

- Patient Wait Times Guarantee funded through the 10-Year Plan to Strengthen Health Care.
- Certainty for 2006–07 Equalization and Territorial Formula Financing payments.
- Funding of \$3.3 billion to provinces and territories for short-term pressures in post-secondary education, affordable housing and public transit.
- Significant investments in infrastructure.

#### **Competitiveness and efficiency of the Canadian economic union**

- Significant tax reductions for small business and large corporations to create jobs and grow Canada's economy.
- Comprehensive personal income tax relief.
- Measures for education and training, including apprenticeships, and increased support for students.
- Investments to promote research and innovation.
- Commitment to work with provinces and territories toward a common securities regulator.
- Additional support for immigration settlement and integration programs, plus taking first steps toward the establishment of a Canadian agency for assessment and recognition of credentials.
- Measures to enhance financial security.

#### **Effective collaborative management of the federation**

- Implementation of commitment for greater provincial and territorial participation at the international level (UNESCO).
- Additional support for agriculture.
- Proposal to work to reduce the welfare wall through development of a Working Income Tax Benefit.

The Government is committing to further action in the coming year after consultations with provinces and territories and broad discussions.

**The Government intends to bring forward key proposals by fall 2006**

- A new approach for allocating unplanned federal surpluses.
- Renewed and strengthened Equalization and Territorial Formula Financing programs.
- A new approach to long-term funding support for post-secondary education and training.
- A new framework for long-term funding support for infrastructure programs.

The Government wants to foster a rich dialogue on how to move ahead and wants to ensure widespread participation in these discussions. To that end, the Government will seek input from a variety of sources. The Government will encourage Canadians to contribute to this important national debate by establishing a website where all interested stakeholders can make submissions and become better informed of progress on the Government's actions. The Government will seek the views of academics and experts on the approach outlined in this paper at roundtable discussions that will be held over the summer. A key element in those discussions will be to ensure that governments have access to the revenues consistent with their responsibilities.

The Government will undertake extensive consultations with provinces and territories on the specific issues set out in this paper. It will also be essential to ensure that the perspectives and priorities of cities and communities are understood. The Minister of Finance will play a key role in these discussions. He will meet with his provincial and territorial counterparts as soon as possible to initiate discussions on fiscal arrangements issues, on proposals for the allocation of year-end surpluses, and on ways to strengthen the economic and social union and improve competitiveness, including:

- Examining the benefits of directing a portion of unplanned federal surpluses to the Canada Pension Plan/Quebec Pension Plan.



- How best to put Equalization and Territorial Formula Financing on a formula-based footing again.
- Determining the most appropriate arrangements for long-term funding commitments for post-secondary education and training.
- Moving forward to strengthen the economic union, including exploring ways to enhance tax harmonization and establish a common securities regulator.

Other consultations with provincial and territorial governments will also play an important role in moving ahead:

- The Minister of Intergovernmental Affairs will seek perspectives on the Government's broad approach to the fiscal imbalance issue, including examining the merits of limiting the federal spending power in specific areas, and on ways to build a new, open relationship among governments.
- The Minister of Human Resources and Social Development will initiate discussions this spring with provinces and territories on the overall objectives for post-secondary education and training, appropriate roles, and on developing a framework for ensuring measurable results and accountability in respect of funding support.
- The Minister of Health will discuss with provinces and territories how the significant and increasing federal support for health care can best be used to support implementation of the 10-Year Plan to Strengthen Health Care, including improved reporting and the Patient Wait Times Guarantee.
- The Minister of Transport, Infrastructure and Communities will discuss the federal role in infrastructure with a view to putting federal funding on a predictable, long-term track and to ensuring accountability to Canadians for infrastructure investments by all governments.
- The Minister of Finance will consult with the Federation of Canadian Municipalities before the development of the federal budget to ensure that the perspectives and priorities of cities and towns are understood and reflected.

Parliament will be an important participant in this national dialogue. The Government will look to parliamentarians to provide guidance on measures to address the concerns about fiscal imbalance in Canada.



All of these consultations will help lay the groundwork for productive discussions among First Ministers in the fall of 2006 to consider the broad range of issues identified in this paper.

Budget 2007 would bring forward funding and legislation required to implement the Government's proposals.





# Annex 1

## A BRIEF HISTORY OF THE FISCAL RELATIONS DEBATE IN CANADA







This annex summarizes:<sup>1</sup>

- The historical evolution of fiscal relations in Canada.
- The issues raised in past debates on fiscal relations.
- The extensive contributions to the current debate by numerous independent commissions and parliamentary committees, provinces and territories, public policy institutes, think tanks and academics.

## Historical Evolution of Fiscal Relations in Canada

Federal and provincial roles and responsibilities have evolved throughout Canadian history in response to sometimes dramatic changes in circumstances (see box below).

While the terms themselves were not used in earlier debates, many of the major events of the 20th century—the Great Depression of the 1930s, the two World Wars, the emergence of the post-war welfare state—all involved dramatic shifts in “fiscal balance” either vertical (between the federal and provincial governments) or horizontal (e.g. changing fiscal disparities among the different provinces).

Fiscal relations have had to evolve alongside these shifts in roles and responsibilities—and corresponding shifts in fiscal balance. Throughout Canada’s history, federal and provincial-territorial governments have found a variety of ways of meeting these challenges. In many cases, adjustments to shifts in fiscal balance were achieved through incremental spending and taxation choices by individual governments. In other cases, they involved coordinated action by federal and provincial-territorial governments to realign revenues or expenditure responsibilities. In only a few cases were constitutional changes involved.

The variety of fiscal rebalancing mechanisms used over the years reflects a high degree of flexibility in Canadian fiscal federalism. Unlike many other federal countries, both the federal and provincial-territorial orders of government are able to exercise significant autonomy across a broad range of expenditure and taxation areas. As a result, all governments in Canada are able to raise revenues from all major tax fields, enabling them to shift relative emphasis on different tax fields over time in response to changes in roles and responsibilities.

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<sup>1</sup> Note: Summaries have been prepared by the Department of Finance Canada, which takes responsibility for any errors or omissions.



### A Brief History of Fiscal Relations in Canada

Early in Canada's history, the largest part of expenditure responsibilities and most of the revenues from the major tax fields then in use (primarily customs, excise and indirect taxes) lay with the federal government.

However, by the 1920s, the role of provinces in delivering programs and services (including the predecessors of many social programs today) had already grown significantly. Their own-source revenues had also increased substantially, as provincial sales taxes, personal income taxes and corporate taxes came to be widely used. The uncoordinated presence of both federal and provincial governments in these tax fields came to be known as the era of the "tax jungle" in Canada and resulted in a vigorous debate over the need for greater clarity in the allocation of taxing powers and the need to harmonize federal and provincial taxes.

The Great Depression of the 1930s had a dramatic impact on the revenues and expenditure requirements of both orders of government—but especially the provinces, given their role in providing income support to persons in need. The resulting financial strain led to calls for a major restructuring of federal and provincial roles and responsibilities in relation to both taxing powers and expenditure responsibilities—and for new federal transfers to the provinces.

The Second World War resulted in an equally dramatic change to the pattern of government expenditures and revenues: provincial expenditures declined as employment increased while federal defence expenditures rose markedly. The fiscal rebalancing required as a result of these developments was achieved through temporary "tax rental agreements," under which provinces "leased" a number of tax fields to the federal government, including personal and corporate income taxes.

In the years following the war, provinces re-entered these tax fields as the federal government reduced its own taxes as a result of demobilization. Provinces also resumed their pre-war expenditure responsibilities and began to take on new roles. To avoid a return to the "tax jungle" of earlier decades, federal and provincial governments agreed to harmonize their personal and corporate income taxes to a substantial degree.

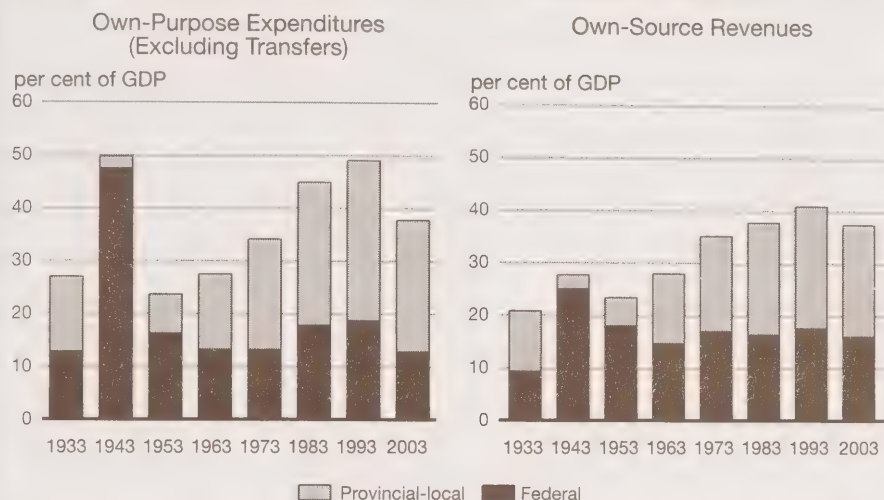
From the 1950s to the 1970s, the development of most of the major social programs familiar to Canadians today (in the fields of health, education and social services) led to significant new pressures on provincial and territorial expenditures, corresponding increases in provincial-territorial taxes and significant increases in federal transfers, including both cash transfers and formal transfers of tax room from the federal government to provinces and territories.

The period starting in the 1980s was marked by consolidation of Canada's system of intergovernmental fiscal relations. By the mid-1990s, increasingly large deficits and debt burdens, especially those of the federal government, led to fiscal restraint that culminated in significant reductions across a wide range of federal expenditures, including transfers to provinces and territories.



Chart A1.1

## Fiscal Balance Among Governments Has Undergone Significant Shifts Over the Course of Canada's History



Sources: National Accounts (1963 to 2003); Statistics Canada historical government finance statistics (1933, 1943 and 1953); Department of Finance Canada calculations. Historical data for 1933 and 1943 are not strictly comparable to later National Accounts data.

## Past Debates on Fiscal Relations

Given their importance in supporting programs and policies that meet the evolving needs of Canadians, fiscal relations have naturally been the focus of much public debate over the years (see box below). Several key themes have emerged in these debates. Most prominent are discussions of the ongoing need for:

- Measures to address fiscal disparities among provinces.
- A high degree of transparency and clarity in federal and provincial roles and responsibilities in order to ensure ongoing accountability to taxpayers for both taxes raised and services provided.
- Changes to the range and level of taxes raised by governments and to intergovernmental transfers to respond to significant changes in expenditure responsibilities.
- Tax harmonization and other mechanisms to achieve cooperation and coordination of the joint occupancy of tax fields by different orders of government and collaborative management in areas of shared jurisdiction.



### **Key Issues Raised in Past Fiscal Relations Debates**

#### **Rowell-Sirois Commission**

*Report of the Royal Commission on Dominion-Provincial Relations, 1940*

- Federal government assume all provincial debts.
- Provincial governments cede corporate income, personal income and estate taxes to the federal government.
- Unconditional grants to the less prosperous provinces.
- Unemployment insurance assigned to the federal government.

#### **Carter Commission**

*Report of the Royal Commission on Taxation, 1966*

- Federal government to act as collection agent for personal income taxes; federal and provincial rates should be harmonized.
- Corporate income taxes left to the federal government.
- Provinces to control retail sales taxes.
- Tax system criticized for inefficiency and lack of fairness, harmonization and consultation.

#### **Breau Committee**

*Fiscal Federalism in Canada: Report of the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements, 1981*

- Ceiling on Equalization on account of resource revenues, but all resource revenues to be included.
- Federal government to have some responsibility for income redistribution.
- Need for better fiscal harmonization, economic coordination and accountability for fiscal arrangements.
- Federal support for higher education to be separate from support for health, with clearer program conditions for health.





## **Key Issues Raised in Past Fiscal Relations Debates (cont'd)**

### **Economic Council of Canada**

*Financing Confederation: Today and Tomorrow, 1982*

- Correction of fiscal imbalance through raising taxes, restraining expenditures, or both.
- Need for better harmonization while maintaining a high degree of individual autonomy.
- Health care and post-secondary education transfers to be separate, and monitored more closely for greater accountability.
- Resource revenues included in Equalization, but only equalized as if distributed to provincial residents.

### **MacDonald Commission**

*Report of the Royal Commission on the Economic Union and Development Prospects for Canada, 1985*

- Equalization based on representative tax system, 10-province standard and partial inclusion of resource revenues.
- Federal government to consult provinces before making tax changes that would also affect them; greater tax harmonization.
- Federal spending power to be retained, but with some conditions.
- Need for better public accountability, transparency and harmonization.



### The Current Debate

Many of the debates from the past still resonate today, albeit with new elements that reflect particular developments since the mid-1990s.

In 2002, the report of the Séguin Commission, *A New Division of Canada's Financial Resources*, brought considerable attention to concerns over an emerging fiscal imbalance. Since then, there have been many contributions to the debate on fiscal relations in Canada.

As noted below, several independent commissions and panels and parliamentary committees have made extensive recommendations to address current strains within the federation, as have individual provincial and territorial governments, public policy institutes, and academics.

#### Independent Commissions and Parliamentary Committees

##### Séguin Commission

*A New Division of Canada's Financial Resources*, 2002

- Additional financial resources of \$2 billion in the short term and \$3 billion in the medium term for Quebec to assume the responsibilities under its jurisdiction; \$8-billion increase for the provinces overall.
- Eliminate federal health and social transfers through a new division of tax room.
- Cede GST base to the provinces (or accept new division of personal income tax field); new division of taxation must not lead to federal deficits.
- 10-province Equalization standard; eliminate floor and ceiling provisions; full inclusion of all revenues.
- Maintain the right to opt out of federal programs with full compensation.
- A genuine, permanent and effective process of exchanges and discussion between the two orders of government on intergovernmental fiscal relations.

##### Standing Senate Committee on National Finance

*The Effectiveness and Possible Improvements to the Present Equalization Policy*, 2002

- Return to a 10-province Equalization standard.
- Remove ceiling on Equalization payments, but retain floor provisions.



## **Independent Commissions and Parliamentary Committees** (cont'd)

### **Standing Senate Committee on National Finance** (cont'd)

- Continue to include non-renewable natural resource revenues in Equalization, but increase the share of entitlements sheltered when provinces' non-renewable resource revenues increase.
- Establish consultation process between federal government, provinces and Statistics Canada to allow provinces to assess and comment on changes in how Equalization is calculated.
- Review Equalization provisions of the Atlantic Accords to determine if they have met the design intent.

### **House of Commons Standing Committee on Finance**

*The Existence, Extent and Elimination of Canada's Fiscal Imbalance, 2005*

- Governments should be able to finance their spending responsibilities without imposing unduly high taxes.
- Comprehensive approach to transfer arrangements to minimize the use of ad hoc bilateral arrangements.
- Fiscal arrangements to respect principles of adequacy, sustainability, equity, efficiency, transparency, accountability and consistency with constitutional responsibilities.
- Canada Social Transfer (CST) to be split into separate post-secondary education and social programs/social assistance transfers and grow at a rate similar to that of health transfers under the 10-Year Plan of 2004.
- Federal-provincial-territorial review of fiscal capacity every three years to ensure governments are able to fulfill their constitutional responsibilities.

### **Oneill review of federal fiscal forecasting**

*Review of Canadian Federal Fiscal Forecasting—Processes and Systems, 2005*

- Federal government to shift from a no-deficit target to a fiscal rule of achieving a surplus, on average, over the economic cycle, increasing its focus on medium/long-term.
- If no-deficit rule is retained, provide for contingent allocations of unanticipated surpluses among tax cuts, spending initiatives and debt reduction.
- Increase the transparency of budget-related information.



### **Independent Commissions and Parliamentary Committees** (cont'd)

#### **Council of the Federation Advisory Panel on Fiscal Imbalance**

*Reconciling the Irreconcilable: Addressing Fiscal Imbalance in Canada, 2006*

- Increase total cash for health and social transfers by \$4.9 billion with new funding mainly targeted to the CST, and automatic escalator of 4.5 per cent for CST and 6 per cent for Canada Health Transfer (CHT) until 2013–14.
- Create a new Tax Point Adjustment program: de-link the existing tax transfers from CHT/CST cash to create a stand-alone transfer. Tax points would continue to be fully equalized to the “top province” standard.
- Base Equalization payments on a 10-province standard with full resource inclusion; address volatility through the use of a moving average; scale down entitlements to achieve federal affordability.
- Abandon the Territorial Formula Financing (TFF) fixed framework and return to separate formula-based grants with funding increases.
- Provide more than equal per capita funding to the territories for national sectoral programs, expedite negotiations on the devolution of lands and resources and provide Nunavut with “extraordinary investment.”
- Establish a First Ministers’ Fiscal Council to deal with intergovernmental fiscal issues, and an independent research organization.

#### **Expert Panel on Equalization and Territorial Formula Financing**

Forthcoming, 2006

The Panel will review and provide advice on:

- The allocation of Equalization and TFF including consideration of the current representative tax system and various revenue sources such as natural resource revenues.
- Mechanisms to ensure that payments for programs to provinces and territories are stable and predictable.
- Evidence-based aggregate measures of the evolution in fiscal disparities among provinces, and of the evolution of the costs of providing services in the North.
- The need for a permanent and independent body to provide ongoing advice on the allocation of Equalization and TFF.



## **Parliamentary and Government-Commissioned Reports on Health Care**

### **Quebec's Commission of Study on Health and Social Services**

*Emerging Solutions: Report and Recommendations* (Clair Report, 2000)

### **A Framework for Reform**

*Report of the Premier's Advisory Council on Health* (Alberta)  
(Mazankowski Report, 2001)

### **British Columbia's Select Standing Committee on Health**

*Patients First: Renewal and Reform of B.C.'s Health Care System*  
(Roddick Report, 2001)

### **Saskatchewan's Commission on Medicare**

*Caring for Medicare: Sustaining a Quality System* (Fyke Report, 2001)

### **Alberta's M.L.A. Task Force on Health Care Funding and Revenue Generation**

*A Sustainable Health System for Alberta* (Graydon Report, 2002)

### **Health Renewal**

*New Brunswick Premier's Health Quality Council Report* (2002)

### **State of the Health Care System in Canada**

*Final Report of the Standing Senate Committee on Social Affairs, Science and Technology* (Kirby Report, 2002)

### **Commission on the Future of Health Care in Canada**

*Building on Values: The Future of Health Care in Canada*  
(Romanow Report, 2002)





### **Provincial and Territorial Governments**

#### **Newfoundland and Labrador**

Budget address, March 2006

- Acknowledge the benefits of the offshore arrangement.

#### **Prince Edward Island**

Budget address, March 2006

- Ensure that Equalization is adequate for provinces without natural resources.

#### **Nova Scotia**

Budget Address, April 2005.

- Acknowledge the benefits of the offshore arrangement.

#### **New Brunswick**

Budget address, March 2006 and *New Brunswick's Perspective on the Equalization Program*, July 2005

- Restore a 10-province standard for Equalization that includes all natural resource revenues.
- Continue a "new, dynamic partnership" with the federal government through cost-sharing of infrastructure investment and other priorities.

#### **Quebec**

Inaugural Address, March 2006 and Budget Address, March 2006

- Restore a 10-province standard for Equalization that includes all natural resource revenues.
- Find "common ground" on day care, post-secondary education (PSE), social assistance, and climate change and restore federal PSE transfers to previous levels.





## **Provincial and Territorial Governments (cont'd)**

### **Ontario**

*A Fair Share: A Strong Ontario for a Stronger Canada/Ongoing Campaign*

- Reduce "\$23-billion gap" between federal revenues and expenditures in Ontario.
- Ensure that health and social transfer programs are provided on an equal per capita cash basis.
- One clear Equalization program.
- Call for a Royal Commission.

### **Manitoba**

*A New Focus on Fiscal Relations, March 2006*

- Restore a 10-province standard for Equalization that includes all natural resource revenues.
- Divide Canada Social Transfer into three separate and more generous transfers for PSE, social services and early childhood initiatives.
- Consider addressing "third-tier" issues through new, needs-based transfers outside of Equalization.

### **Saskatchewan**

"Federal Equalization: Saskatchewan's Case for Fairness," provincial budget, April 2006 and *Equalization Reform: A Fair Deal for Saskatchewan*, June 2005

- Negotiate "Energy Accord" that exempts Saskatchewan's oil and gas revenues from Equalization.
- Restore a 10-province standard but exclude non-renewable natural resource revenues.

### **Alberta**

Letter to the Major Party Leaders, December 2005

- Achieve a "fiscally balanced" federation.
- Increase federal funding for PSE, invest "unallocated" federal fuel taxes in transport infrastructure.

### **British Columbia**

Throne Speech, February 2006

- Amend Canada Health Act to include a sixth ("sustainability") principle for health care funding.

### **Territories**

Budget addresses, February and March 2006

- Enhance Territorial Formula Financing and devolve responsibility for resources to the territories.
- Provide support for Alaska Pipeline and Mackenzie Valley Pipeline.
- Lift \$300-million borrowing limit on the Northwest Territories.



## **Public Policy Institutes and Think Tanks (Selected Studies)**

### **Atlantic Institute for Market Studies**

*Equalization Reform That Works: Taking seriously the idea that incentives matter and The Old Shell Game, or the Mystery of the Missing Fiscal Imbalance, 2005*

- Removal of non-renewable natural resources and sales of Crown corporation assets from Equalization; 10-province standard; some ceiling on Equalization; part of Equalization allocated to debt repayment.
- One-off deals to be replaced by a rules-based Equalization formula.
- Evidence of a fiscal imbalance weak, given that provinces can increase their own taxes.

### **Canadian Council of Chief Executives**

*From Bronze to Gold: A Blueprint for Canadian Leadership in a Transforming World, 2006*

- While accountability is important, governments should realign responsibilities to match the evolving needs of Canadians, e.g. provinces delegating regulation of the securities market.
- The perception of fiscal imbalance, health cost pressures and “ad hoc deals” are leading to calls to better align spending responsibilities and taxing capacities.

### **C.D. Howe Institute**

McKenzie, 2005; Poschmann and Tapp 2005; Smart, 2005

- Reduce federal taxes (GST or personal income tax) to create tax room in favour of the provinces.
- Reduce transfers to provinces to partially compensate for the loss in federal revenues.
- Eliminate retail sales taxes in favour of value-added taxes and federal-provincial tax harmonization.
- Retain the federal role in addressing horizontal equity issues.

### **Conference Board of Canada**

*Fiscal Prospects for the Federal and Provincial/Territorial Governments, 2002*

- Vertical fiscal imbalance is a situation where the distribution of revenues between the federal and provincial orders of government is inconsistent with the cost of meeting their constitutional spending responsibilities.
- A vertical imbalance exists; without structural changes it will widen in the future.
- Projections show large and growing federal surpluses over the next two decades and small provincial sector deficits; new projections recently done for the Council of the Federation Advisory Panel on Fiscal Imbalance.



## **Public Policy Institutes and Think Tanks (Selected Studies)** (cont'd)

### **Fraser Institute**

*Is There a Fiscal Imbalance? Yes, 2005*

- The federal government should remove itself from areas of provincial jurisdiction.
- Tax room should be vacated to the provinces.
- Equalization payments to less-wealthy provinces should be sensibly structured.

### **Institute for Competitiveness and Prosperity**

*Fixing Fiscal Federalism, 2005*

- \$16.1-billion "gap" between federal expenditures made and revenues collected in Ontario.
- Canadian system of regional redistribution harmful to prosperous provinces and ineffective in raising competitiveness and prosperity levels in poorer provinces.
- Federal trend toward current "consumption" and away from "investing" in future prosperity.
- Transfer payments need to be rethought and the employment insurance program converted to a true insurance program.
- Introduce new mechanisms to deal with unanticipated federal surpluses.

### **Institute for Research on Public Policy**

*Courchene, St-Hilaire, 2005*

- The federal government occupies too much tax room and does not provide sufficient transfers.
- Evidence of both excess vertical fiscal gap and fiscal imbalance.
- Resource revenues should be equalized, at least in part, but representative tax system inappropriate for resource revenues.
- Equalization should be reworked to integrate and accommodate recent agreements such as the offshore arrangements.
- Both the funding and the allocation-of-benefit sides of the Equalization formula should be considered.
- Introduce a formal mechanism for allocating unanticipated budget surpluses.



### Selected Academic Contributions

#### Robin Boadway

*Should the Canadian Federation be Rebalanced? 2004*

- Imbalance should be addressed by increasing federal transfers to the provinces.
- The federal share of tax room should be “jealously guarded and even enhanced.”
- Transfers should not depend on the size of the federal surplus.
- Equalization should be based on a 10-province standard and include natural resource revenues.
- Social transfers should be disaggregated into three parts: health, welfare and post-secondary education, increased in accordance with some index of provincial spending requirements and allocated among provinces on the basis of need.
- Address the process of managing fiscal relations to make it more accountable and transparent.

#### Bev Dahlby

*Dealing with the Fiscal Imbalances: Vertical, Horizontal, and Structural, 2005*

- A vertical fiscal imbalance exists if the marginal cost of raising tax revenue varies between the orders of government.
- Mobility of tax bases is one reason why the federal government should raise more in taxes than it spends and transfer part of the extra revenues to provinces.
- Federal surpluses and provincial deficits are not an indication of vertical fiscal imbalance.
- No pressing need to expand the scope of equalization, i.e. adding a needs component.
- A revised representative tax system with partial Equalization of non-renewable resource revenues and property taxes would be an adequate basis for Equalization over the long term.
- The five provinces that levy retail sales taxes should switch to value added taxes and the GST should be reduced to 5 per cent and provinces should increase their sales tax rates.
- Excise taxes on alcohol, tobacco and motive fuels should be turned over to the provinces; resulting federal shortfall could be reduced by cutting transfers to provinces.





## **Selected Academic Contributions (cont'd)**

### **Harvey Lazar**

*Trust in Intergovernmental Fiscal Relations, in Canadian Fiscal Arrangements: What Works, What Might Work Better, 2006*

- Need to have stable and reliable federal transfers to the provinces.
- Reductions in federal transfers should not exceed federal cutbacks to its own programs.
- Remaining vertical imbalance to be rectified through transfers to the provinces and direct spending initiatives.
- Need for greater transparency in federal-provincial fiscal relations.
- Establish an independent finance commission to review intergovernmental relations.

### **André Plourde**

*Natural Resource Revenues and Fiscal Equalization: A Partial Overview of Selected Issues, 2005*

- Non-renewable resource revenues should not be equalized if saved/invested rather than spent.
- The fact that almost all revenues from non-renewable resources were historically spent makes it difficult to justify treating such revenues differently from renewable resource revenues.
- Using average tax rates to estimate capacity could discourage exploitation of high-cost sources; it is better to use actual revenues.

### **François Vaillancourt**

*Reforming Equalization in Canada: Some Observations, 2005*

- A single standard of Equalization among provinces should be used.
- The choice of the overall level of Equalization is a political decision.
- Natural resources should be shared among provinces using a pooling mechanism.
- Representative tax system but with improvements.
- Increase transparency and publicly available information by setting up a five-year program of research and analysis, jointly managed by the federal and provincial governments.





# Annex 2

## RECENT EVOLUTION OF FISCAL BALANCE IN CANADA







This annex summarizes key developments in the evolution of fiscal balance in Canada over the last few decades, including:

- The return to surpluses by both federal and provincial-territorial governments after years of large deficits.
- The significant decline of debt ratios of both orders of government.
- The marked decline in both federal and provincial program spending ratios since the mid-1990s.
- The broad access of both federal and provincial governments to all major tax fields.
- The significant tax reductions made in recent years, especially in the case of federal taxes.
- The significant reinvestment in federal cash transfers to provinces and territories in recent years, after significant cuts in the mid-1990s.
- The significant narrowing of interprovincial economic and fiscal disparities.

## **Budgetary Balances and Debt Burdens**

The past quarter-century has witnessed dramatic changes to federal and provincial-territorial budgetary balances. The 1980s and early 1990s were characterized by large, chronic federal deficits, which peaked at more than 8 per cent of GDP in 1984–85. Over this same period, provincial deficits were also significant but did not reach the same levels as those recorded by the federal government.

After some improvement in the late 1980s, the 1990–91 recession resulted in a deterioration of the fiscal situation for provinces and territories and a further setback for federal efforts to reduce its deficit. For both orders of government, spending control as well as the post-recession return to economic growth led to a significant turnaround from large deficits to surpluses.



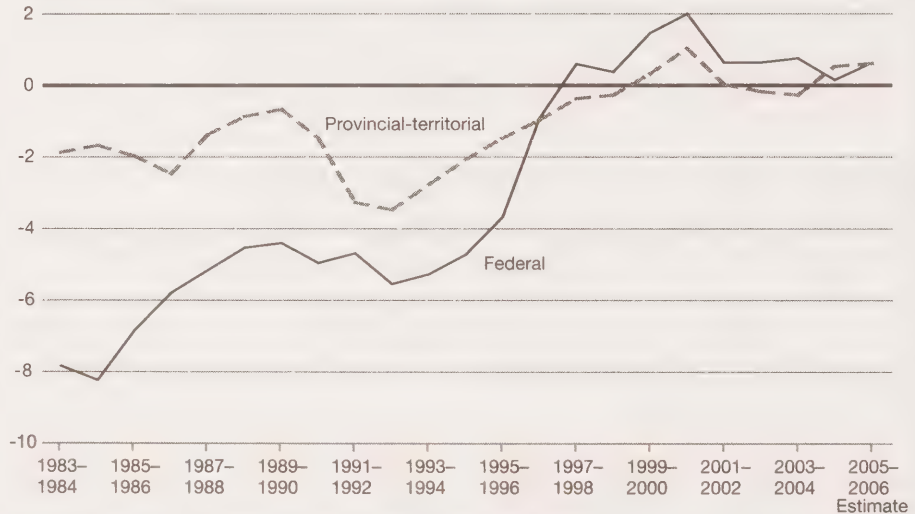
The federal government recorded its first surplus in 1997–98 and provinces achieved a combined positive budgetary balance in 1999–2000 after decades of deficits. With the projected surplus in 2005–06, provincial-territorial governments will have recorded a combined positive budgetary balance in five of the past seven years.

Eight provinces are forecasting balanced budgets or surpluses in 2005–06 and 2006–07, with the remainder also seeing a considerable improvement in their fiscal situation over the last few years.

Chart A2.1

### Return to Surpluses by Both Federal and Provincial-Territorial Governments After Years of Large Deficits

per cent of GDP



Sources: Federal and provincial-territorial Public Accounts and budgets.



Table A2.1

# Substantial Improvement in Budgetary Balances in Recent Years

	2001-02	2002-03	2003-04	2004-05	Estimate 2005-06	Projection 2006-07
	(millions of dollars)					
<b>Federal</b>	<b>6,742</b>	<b>7,073</b>	<b>8,891</b>	<b>1,456</b>	<b>8,000</b>	<b>3,600</b>
N.L.	-468	-644	-914	-489	77	6
P.E.I.	-17	-55	-125	-34	-18	-12
N.S.	113	28	38	165	78	93
N.B.	79	1	-173	242	117	22
Que.	22	-728	-358	-664	0	0
Ont.	375	117	-5,483	-1,555	-1,369	-2,350
Man.	63	4	13	405	3	3
Sask.	1	1	1	383	298	102
Alta.	1,081	2,133	4,136	5,175	7,375	4,096
B.C.	-1,184	-2,737	-1,275	2,575	1,475	600
Y.T.	-21	-5	12	5	38	9
N.W.T.	120	-34	-65	-17	18	31
Nun.	-47	12	7	-8	6	-8
<b>Total provincial- territorial</b>	<b>117</b>	<b>-1,907</b>	<b>-4,187</b>	<b>6,184</b>	<b>8,098</b>	<b>2,592</b>

Sources: Federal and provincial-territorial Public Accounts and budgets.

Reflecting improvements in budgetary balances, both federal and provincial-territorial debts have declined as a share of gross domestic product (GDP), with the federal debt ratio falling more dramatically. However, federal debt as a share of GDP still exceeds that of most provinces and remains significantly higher than the provincial average.

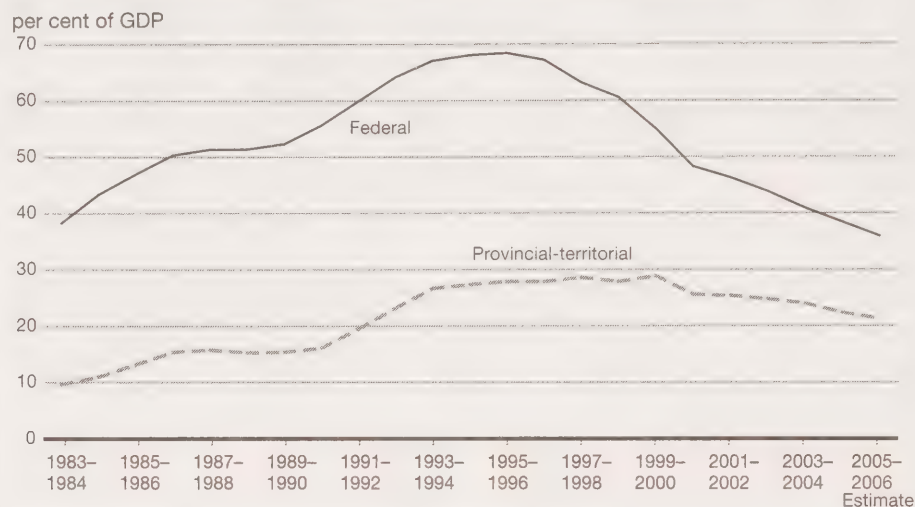
Lower debt-to-GDP ratios, combined with lower interest rates and an improved credit rating, have enabled both orders of government to allocate a smaller portion of revenues to debt interest payments and a greater portion to program expenditures, tax reductions and debt repayment. Both orders of government have also benefited from increased revenues generated by sustained economic growth.

Overall, Canadians witnessed an impressive fiscal recovery for both orders of government in the past decade. However, such a recovery was made possible only by making difficult choices in the mid-1990s to reduce spending.



Chart A2.2

## The Federal Debt-to-GDP Ratio Has Been Declining Rapidly but Still Exceeds That of the Provinces and Territories



## Program Spending

Program spending expressed as a share of GDP provides a good measure of spending trends and of the size of governments relative to the economy. It is important to examine the data over a long period of time in order to distinguish between cyclical and structural trends.

Federal program spending as a share of GDP has declined significantly since 1983-84. As a result of spending restraint and strong economic growth, the ratio of federal program spending to GDP declined steadily throughout the latter half of the 1980s. The 1990-91 recession triggered increases in certain federal expenditures like employment insurance, which contributed to a rise in the program spending-to-GDP ratio. The federal government underwent a program of expenditure review and restraint between 1993-94 and 1996-97, which was an essential factor in its fiscal recovery.

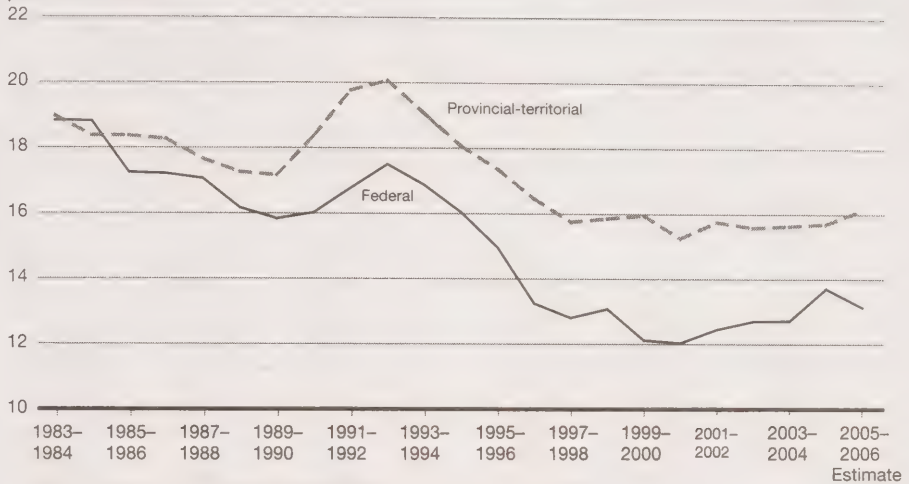




Chart A2.3

### Federal and Provincial-Territorial Program Expenditures Have Both Declined Significantly Over the Last Two Decades

per cent of GDP



Sources: Federal and provincial-territorial Public Accounts and budgets.

Since 1983–84, provincial-territorial program spending has also declined as a share of GDP, but to a lesser extent. Provinces and territories were also hit hard by the recession, which caused a significant increase in spending on social assistance and social services in the early 1990s. Starting in the mid-1990s, most provinces undertook major restructuring to reduce or stabilize their program expenditures. The sustained job creation over the past decade has also significantly reduced provincial spending pressures in the areas of social assistance and social services.

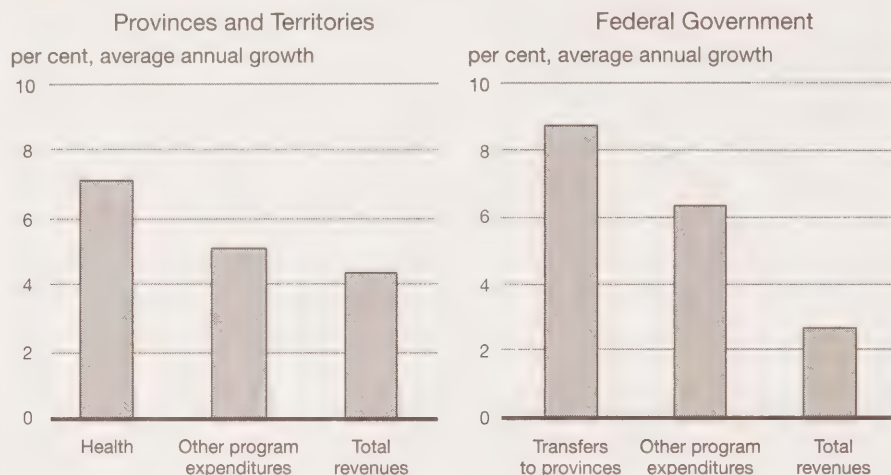
The tighter spending control exercised by both orders of government during the 1990s reflected the need to rebalance government finances after a long period of large and unsustainable deficits.

Since 2000–01, program spending as a percentage of GDP has begun a modest rebound as both federal and provincial-territorial governments addressed significant spending pressures.



Chart A2.4

## Recent Rapid Growth in Provincial-Territorial Health Expenditures Has Been Matched by Growth in Federal Transfers (2000–01 to 2005–06)



Sources: Federal and provincial-territorial Public Accounts and budgets.

Health care has proven to be the number one priority in terms of new investments:

- From 2000–01 to 2005–06, provincial-territorial health care spending increased by an average of 7 per cent annually, compared to an average growth of 4.3 per cent for provincial-territorial revenues.
- The federal government increased its transfers to provinces and territories, in large part to support them in their efforts to address health care needs. Transfers increased by an average of 8.7 per cent annually between 2000–01 and 2005–06, compared to average growth in federal revenues of only 2.6 per cent.

## Access to Revenues

Both orders of government have access to all major sources of tax revenue: personal and corporate income taxes, sales taxes and payroll taxes. Provinces have access to resource revenues, gaming and liquor profits, and property taxes while the federal government has exclusive access to customs import duties as well as taxes on non-residents.

Moreover, among major industrialized federations, only in Canada and the United States do sub-national governments have full control over their tax bases and tax rates—though in some cases, provinces in Canada have chosen to enter into harmonization agreements (notably in the area of income and sales taxes) in order to reduce compliance costs on Canadians and administrative costs.

### Both Orders of Government Have Access to Major Tax Fields

	Federal	Provincial
<b>Common revenue sources</b>		
Personal income taxes	✓	✓
Corporate income taxes	✓	✓
Sales taxes	✓	✓
Payroll taxes	✓	✓
Total in 2005 (billions of dollars)	192.0	130.0
<b>Unique provincial revenue sources</b>		
Resource royalties within provincial jurisdiction		✓
Gaming, liquor profits		✓
Property taxes		✓
Total in 2005 (billions of dollars)		30.3
<b>Unique federal revenue sources</b>		
Customs import duties	✓	
Taxes on non-residents	✓	
Total in 2005 (billions of dollars)	8.4	

Source: National Economic and Financial Accounts.

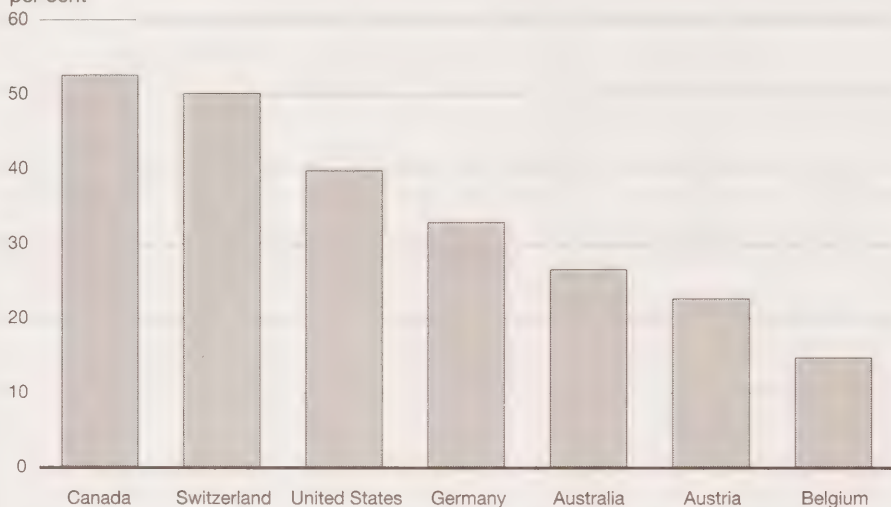


In Canada, sub-national governments raise the largest share of total government revenues among industrialized federal countries, which is a reflection of the high degree of decentralization of the Canadian federation.

Chart A2.5

**Canadian Provinces, Territories and Local Governments Together Account for a Larger Share of Government Revenues Than Sub-National Governments in Other Federal Countries**

per cent



Sources: International Monetary Fund, *Government Finance Statistics Yearbook 2004*; Statistics Canada, *National Economic and Financial Accounts*; U.S. Bureau of Economic Analysis, *National Income and Product Accounts*; Department of Finance Canada calculations.

Given their broad access to major tax fields and the control they exercise over their tax bases and rates, provinces and territories are more fiscally autonomous than their counterparts in other federal countries. In particular, they rely more on own-source revenues—and less on federal transfers—to fund their programs and policies.

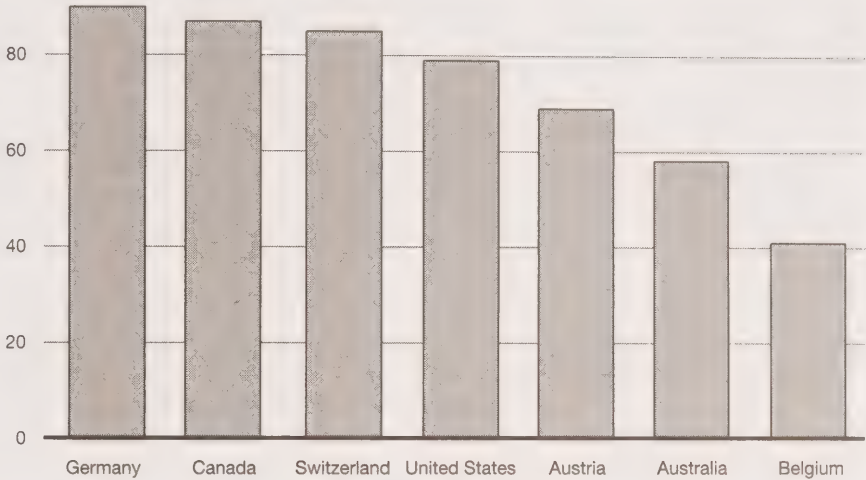


Chart A2.6

**Own-Source Revenues as a Per Cent of Total Provincial-Local Revenues Are Among the Highest in Canada**

per cent

100



Sources: International Monetary Fund, *Government Finance Statistics Yearbook 2004*; Statistics Canada, *National Economic and Financial Accounts*; U.S. Bureau of Economic Analysis, *National Income and Product Accounts*; Department of Finance Canada calculations.

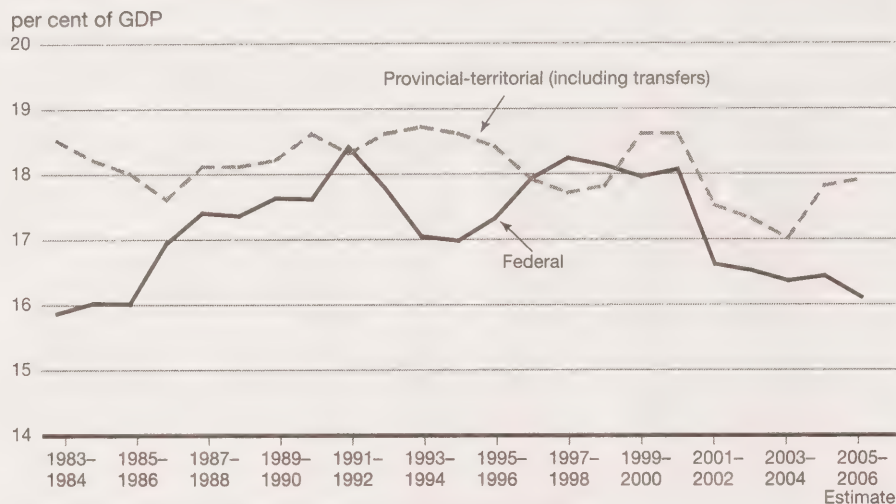
Provincial revenues (including federal transfers) have generally exceeded federal revenues for more than 25 years, with the gap increasing in recent years. While governments have the legal authority to increase their revenues as required, concerns about competitiveness and the overall tax burden of Canadians limit the extent to which they can and should raise additional revenues in practice.





Chart A2.7

## Federal Revenues Have Declined Significantly More Than Those of The Provinces and Territories Since the 1990s



Starting in the late 1990s, most governments in Canada implemented tax reductions, primarily targeting personal and corporate income tax reductions. As a result, revenue-to-GDP ratios declined for both orders of government. For provinces and territories, the rebound in the revenue ratio in recent years is in large part attributable to increases in federal transfers and resource revenues. Federal tax cuts exceeded provincial tax cuts in dollar terms.

Table A2.2

## The Sharper Decline in Federal Revenues is Due in Part to Larger Federal Tax Reductions Since the 1996 Federal Budget

	Federal	Provincial
	(billions of dollars)	
Personal income taxes	-31.5	-21.3
Corporate income and capital taxes	-5.3	-4.6
Employment insurance premiums/payroll taxes	-7.2	-0.4
Other revenue measures <sup>1</sup>	0.8	5.9
Total	-43.2	-22.4

<sup>1</sup> Includes sales taxes, property taxes, health premiums, tobacco taxes, gasoline taxes and various measures to fight tax evasion.

Sources: Department of Finance Canada estimates; provincial governments.





## Federal Cash Transfers

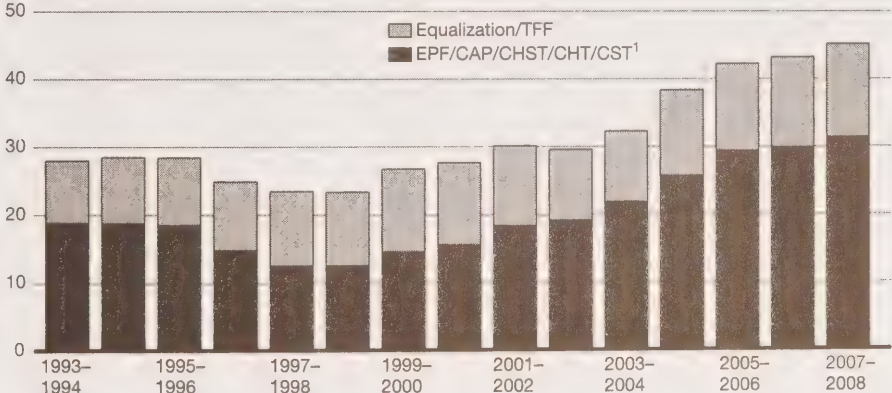
While Canadian provinces are less dependent on federal cash transfers than their counterparts in other federal countries, transfers still represent a significant source of revenue for the provinces and territories.

As part of its deficit reduction efforts, the federal government cut cash transfers to provinces and territories for health care and other social programs by 30 per cent between 1994–95 and 1997–98, from \$18.7 billion to \$12.5 billion. Equalization was not cut but a ceiling did temporarily constrain entitlements in 2000–01. Territorial Formula Financing (TFF) was also subject to a ceiling that limited the growth of grants from 1990–91 to 1993–94, and each territory's Gross Expenditure Base was cut by 5 per cent in the 1995 budget.

Chart A2.8

### Federal Cash Transfers Declined in the Mid-1990s But Have Increased in Recent Years

billions of dollars



¹ Established Programs Financing/Canada Assistance Plan/Canada Health and Social Transfer/Canada Health Transfer, Canada Social Transfer.

Source: Department of Finance Canada.



Since the federal government balanced its budget in 1997–98, federal cash transfers for health and social programs have rebounded substantially:

- By 2002–03, the level of cash transfers was restored to 1994–95 levels.
- In 2006–07, cash transfers will reach \$29.8 billion, an increase of about \$17 billion since 1997–98.
- The Canada Health Transfer (CHT) has also been put on a long-term growth track. The 10-Year Plan to Strengthen Health Care signed in September 2004 (and legislated through to 2013–14) provides for annual increases of 6 per cent in the CHT cash transfers over the life of the agreement.
- Cash payments under the Canada Social Transfer will grow by nearly 3 per cent annually, on average, over the legislated period until 2007–08.

Equalization and TFF transfers were also put on a legislated 10-year growth track through to 2013–14 under a new framework announced in October 2004. However, the new framework constituted a departure from past practice, under which both the level and allocation of these transfers were determined by a formula. As a result, concerns have been raised about the ability of both programs to meet their objectives over the longer term. In particular, there is a broad consensus that the programs need to be returned to a formula-based approach for determining both the level and allocation of entitlements under these two transfers.

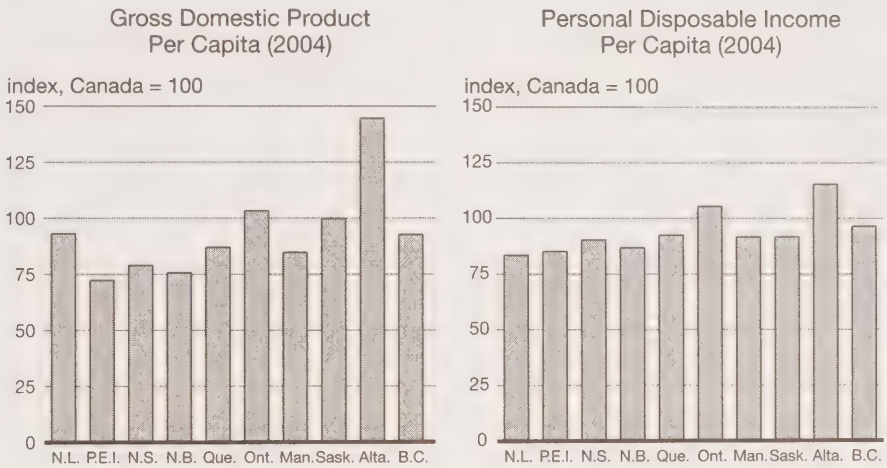


## Regional Disparities

In all countries, there are differences in economic performance across regions. Given the diverse nature of Canada, substantial economic disparities exist.

Chart A2.9

### Significant Economic Disparities Continue to Exist in Canada (indicators of interprovincial disparities)



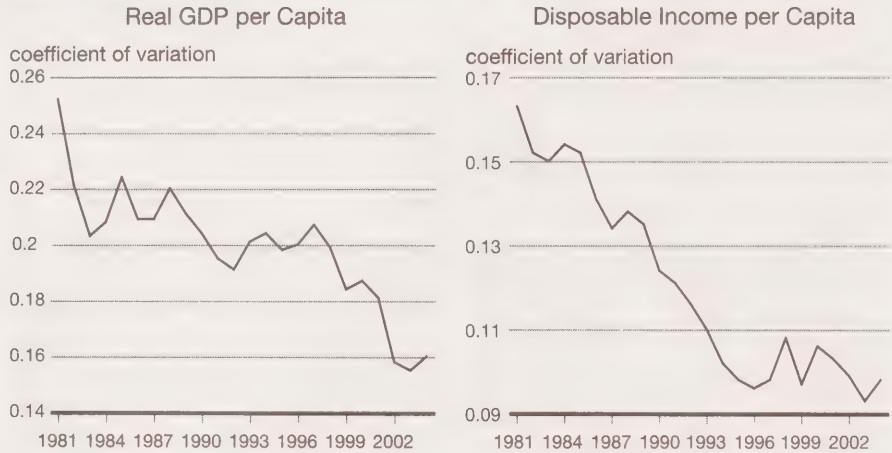
Sources: Provincial Economic Accounts; Statistics Canada.



The coefficient of variation, illustrated in the charts below, measures the magnitude of the disparities across provinces in each year, thus making it a useful indicator to track trends in disparities over time. Even though economic disparities between provinces are still substantial, they have nevertheless declined significantly over the past 25 years.

Chart A2.10

### Economic Disparities Between Provinces Have Narrowed Significantly in Recent Decades



Sources: Provincial Economic Accounts; Statistics Canada.

## Fiscal Equalization

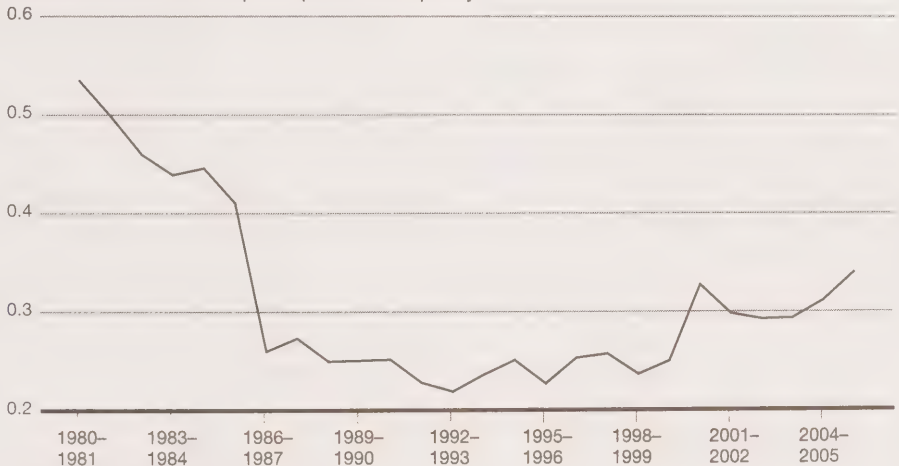
In federal countries—and especially in fiscally decentralized countries such as Canada—these economic disparities translate into fiscal disparities (i.e. differences in the ability to raise revenues) among sub-national governments. The pattern of fiscal disparities in Canada has largely mirrored the pattern of economic disparities.

While fiscal disparities (like economic disparities) have generally declined over the past 25 years, the recent rise in natural resource prices that began in 2000 has generated stronger economic and revenue growth in provinces with significant natural resources (notably Alberta, Saskatchewan, British Columbia and Newfoundland and Labrador). As a result, economic and fiscal disparities have widened somewhat, though they remain significantly smaller than in the early 1980s.

Chart A2.11

### Disparities in Provincial Fiscal Capacity Have Also Narrowed, Albeit With a Modest Widening in Recent Years

coefficient of variation in per capita fiscal capacity



Source: Department of Finance Canada.

Most federal countries, including Canada, have fiscal equalization programs to help reduce fiscal disparities. The principle of equalization is enshrined in subsection 36(2) of Canada's Constitution Act, 1982. Canada's Equalization program significantly reduces fiscal disparities among the provinces (see Annex 3).





## Federal Revenue-Expenditure Balances Across Provinces

In all federal countries, economic disparities and the implicit inter-regional redistribution that results from the operation of federal tax and expenditure policies result in different “balances” between federal revenues and expenditures in different regions. Generally speaking, the residents of more prosperous regions, taken as a whole, receive less federal spending and make larger contributions to federal revenues. The opposite is true in less prosperous regions.

Canada is no different in this regard. Because of their relatively higher incomes, citizens and businesses residing in more prosperous provinces, such as Alberta and Ontario, contribute relatively more to federal revenues than they receive from federal programs.

In Canada, as in other federal countries, the “gaps” between federal revenues and expenditures in different provinces reflect the structure of the tax and transfer systems of the federation, including the progressivity of federal taxes, the targeting of support to individual Canadians or families in need, and the commitment to the reduction of provincial-territorial fiscal disparities.

In particular, a number of factors determine the measured balance of individual regions at any given point in time:

- **Budgetary position of the federal government:** Measuring balances at a given point in time effectively ignores the impacts of deficits and surpluses on future tax and benefit levels. As a result, when federal deficits are large (as in the early 1990s in Canada), federal fiscal balances are distorted in all provinces: redistribution toward less prosperous jurisdictions is exaggerated and redistribution from more prosperous jurisdictions appears smaller. The opposite is true when the federal government runs surpluses (as has been the case in Canada in recent years).
- **The degree of revenue and expenditure decentralization:** The larger the federal share of revenues and expenditures, the greater the degree of redistribution among regions even with uniform federal taxation and expenditure policies. As a result, redistribution resulting from federal policies tends to be smaller in fiscally decentralized federations (such as Canada) than in more centralized federations (such as the U.S.)





- **The degree to which federal policies are designed to be redistributive:** For example, inter-regional redistribution increases with the progressivity of the federal tax system, the degree to which federal programs are targeted to low-income individuals or regions or other needs, and the extent of the national commitment to the reduction of fiscal disparities among provinces and territories.

Changes in the federal budgetary balance are particularly important in explaining recent changes in regional balances:

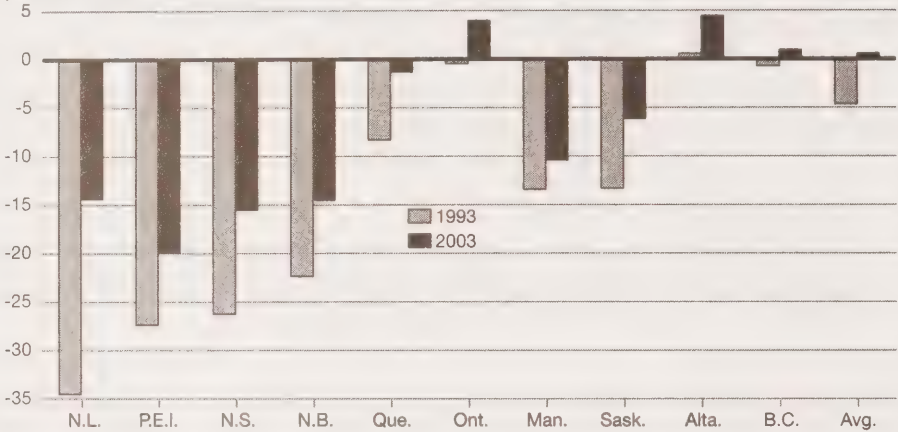
- In 1993, when the federal government recorded a \$38.5-billion deficit, they were negative fiscal balances in all provinces but Alberta: that is, provincial residents were receiving more in federal services and transfers than they paid in federal taxes. The average balance was minus 4.6 per cent of GDP. Even in Ontario there was a negative balance totalling \$1.4 billion.
- This situation was clearly unsustainable since the federal government was borrowing heavily to finance its activities. To address its budgetary deficits, the federal government raised its revenues and reduced its spending. Residents of all provinces contributed to this process of fiscal restraint.
- By 2003, federal fiscal consolidation resulted in the average balance rising by more than 5 per cent of GDP relative to 1993, to an average balance of plus 0.6 per cent of GDP. In Ontario, the fiscal balance increased by 4.5 per cent of GDP during this period. This generalized trend towards improved provincial balances explains the growth in what some observers have referred to as the Ontario “gap,” which increased in aggregate from about \$2 billion (in 1995) to \$18 billion in 2003.



Chart A2.12

### Federal Fiscal Balances Have Risen in All Provinces Since the Mid-1990s as a Result of Improved Federal Finances

per cent of GDP



Sources: Provincial Economic Accounts; Statistics Canada.

In effect, the resulting \$18-billion Ontario “gap” is a reflection of the province’s greater prosperity relative to most other provinces. The “gap” can be decomposed based on the extent to which federal revenues and expenditures in Ontario deviate from the national average:

- About 42 per cent of the “gap” in 2003 is accounted for by above-average revenues collected in Ontario, reflecting above-average incomes and business activity in the province.
- About 14 per cent is accounted for by Ontario’s per capita share of federal debt reduction in 2003.
- About 23 per cent is accounted for by below-average transfers to the province, notably because it did not qualify for Equalization due to its above-average fiscal capacity.

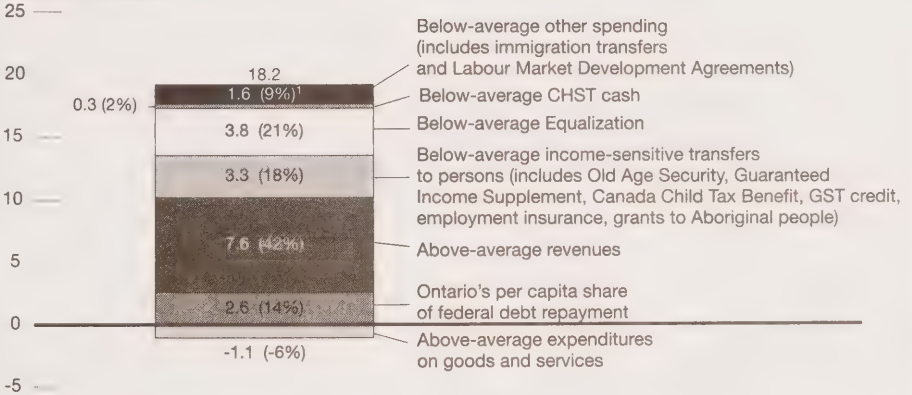
- About 18 per cent was accounted for by below-average payments to Ontario residents for income-tested transfers to persons, such as the Canada Child Tax Benefit, elderly benefits and employment insurance. These reflect the province's above-average personal incomes and below-average unemployment rate.

These four areas accounted for over 97 per cent of the "gap," with the remaining 3 per cent reflecting other smaller expenditures, some of which are more heavily weighted towards Ontario (such as federal spending on goods and services) and others that are not.

Chart A2.13

**The Ontario "Gap" Largely Reflects Its Above-Average Incomes and Below-Average Eligibility for Income- and Needs-Tested Federal Programs (2003)**

billions of dollars



<sup>1</sup> Percentages are per cent of total.

Sources: Statistics Canada, Provincial Economics Accounts; Department of Finance Canada calculations.



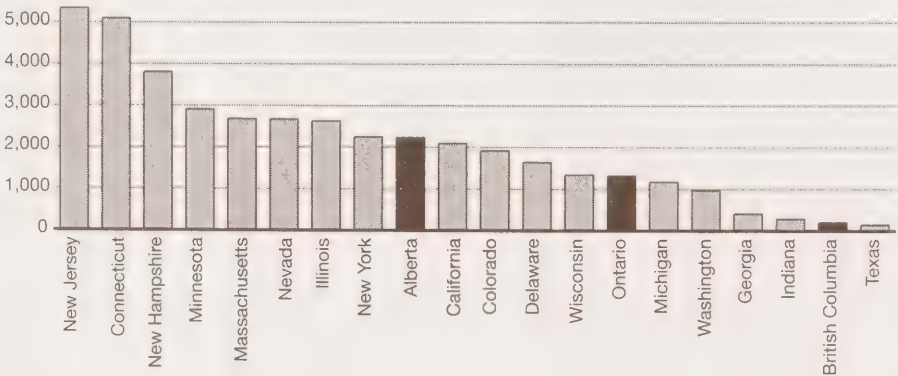
Federal fiscal balances in Canadian provinces are similar in size to those that would be observed across the United States if the federal government in both countries ran balanced budgets, even though the United States does not have an equalization program:

- As noted above, provincial and state “gaps” not only depend on the level of transfers from the federal government to provincial or state governments, but also on the relative size of the federal government, the progressivity of the federal tax system and the extent to which federal expenditures are income- or needs-targeted.
- The chart below therefore reflects the fact that the U.S. federal government’s revenues and expenditures are larger, as a percentage of GDP, than those of the Canadian federal government, as well as the different basis for allocating federal expenditures in the U.S. (e.g. the greater proportion of defence spending in the U.S. and its concentration in particular states).

Chart A2.14

### Federal Fiscal Balances in Canada Are Smaller Than Those That Would Be Observed in the U.S. if Both Federal Governments Had Balanced Budgets (2003)

C\$ per capita  
6,000



Sources: Tax Foundation; Statistics Canada; Department of Finance Canada calculations.

# Annex 3

## MAJOR TRANSFERS









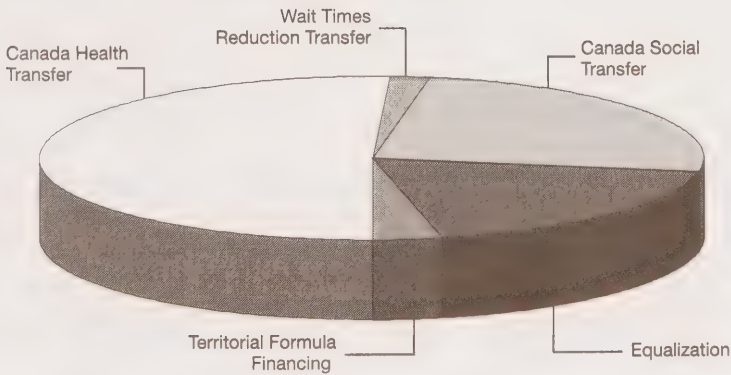
This annex describes the major fiscal transfer programs to provinces and territories and provides a historical overview of the programs.

## Current Fiscal Transfer Arrangements

In 2006–07, the Government of Canada will provide support of \$61 billion to provincial and territorial governments through its major cash and tax transfers including the Canada Health Transfer (CHT), Canada Social Transfer, (CST), Wait Times Reduction Transfer, Equalization and Territorial Formula Financing.

Chart A3.1

### Total Major Federal Transfers in 2006–07: \$61 Billion to Provinces and Territories



Note: Equalization associated with the tax transfers under the CHT/CST is included in both the CHT/CST and Equalization. The total has been reduced by \$1.3 billion to avoid double-counting.

Source: Department of Finance Canada, May 2006.



## Equalization

Equalization was established in 1957. In 1982, the purpose of the program was entrenched in the Canadian Constitution:

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***“Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.”***

---

(Subsection 36(2) of the Constitution Act, 1982)

Because all parts of the country are not equally prosperous, all provincial governments cannot generate comparable revenues, at comparable levels of tax effort, with which to finance public services. The purpose of Equalization transfers is to enable less prosperous provinces to provide public services reasonably comparable to those provided by more prosperous provinces at reasonably comparable levels of taxation.

In 2005–06, eight provinces qualified for Equalization payments: Newfoundland and Labrador, Prince Edward Island, Nova Scotia, New Brunswick, Quebec, Manitoba, Saskatchewan and British Columbia. All provinces except Ontario have qualified at some time in the past. Equalization payments are unconditional, and receiving provinces spend these payments according to their own priorities.

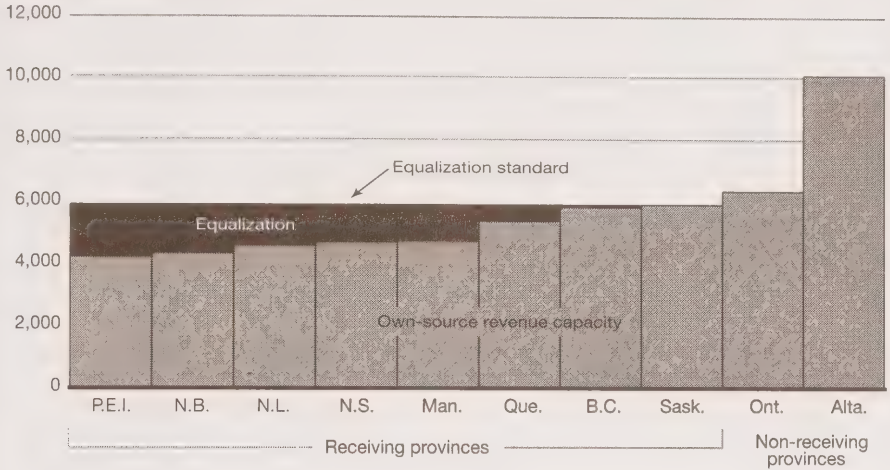
Prior to changes introduced in 2004, Equalization payments for all provinces were calculated according to a formula set out in federal legislation.

- Comparisons were made of the relative capacities of provinces to raise revenues from taxes and other revenue sources.
- The revenue-raising capacity of provinces was calculated separately for each of the more than 30 revenue sources available to provincial and local governments. The program was not based on actual revenues, but on measured fiscal capacity, that is the revenues provinces could raise if they applied tax rates corresponding to the average of the provinces.

Chart A3.2

**How Equalization Worked Prior to the October 2004 Changes**

dollars per capita



Source: Department of Finance Canada.

- Under the formula, less prosperous provinces were brought up to a standard. Between 1982–83 and 2003–04 that standard was the five-province standard—equal to the fiscal capacity of the five “middle-income” provinces. Over the history of the program, the standard has changed several times (see “Equalization Milestones: 1957 to 2004” below).

From 1957 to 2004, Equalization legislation was renewed on a five-year cycle (with the exception of a two-year renewal in 1992). Prior to the expiry of Equalization legislation, and before the introduction of new legislation for the next five-year term, the program underwent an extensive “renewal process,” in consultation with all provinces, during which modifications to the program were considered.

The renewal process involved a comprehensive examination to identify possible technical changes and improvements to the program’s design and structure, notably to reflect the evolution of provincial tax practices.



### Equalization Milestones: 1957 to 2004

1957	<ul style="list-style-type: none"><li>• Equalization established with only three equalized tax bases: personal income tax, corporate income tax and succession duties. Natural resource revenues not taken into account.</li><li>• The Equalization standard was equal to the average fiscal capacity of the two provinces with the highest fiscal capacity ("top two" standard).</li></ul>
1962	<ul style="list-style-type: none"><li>• The 10-province standard (average fiscal capacity of all 10 provinces) was substituted for the "top two" standard.</li><li>• Revenue coverage increased. Natural resource revenues included in the program for first time (with 50 per cent inclusion rate).</li></ul>
1967	<ul style="list-style-type: none"><li>• Number of tax sources further increased to 16. Virtually all provincial revenues now included, but most local government revenues (including property taxes) not included. Inclusion rate for natural resources increased from 50 per cent to 100 per cent.</li></ul>
1972–77	<ul style="list-style-type: none"><li>• Major petroleum price shock in 1973; oil and gas inclusion rate reduced to one-third starting in 1974.</li></ul>
1977	<ul style="list-style-type: none"><li>• Inclusion rate set at 50 per cent for all non-renewable resources (including oil and gas).</li></ul>
1982	<ul style="list-style-type: none"><li>• Five-province standard adopted. Return to full inclusion of natural resource revenue. Inclusion of all local government revenues for first time.</li><li>• Purpose of Equalization entrenched in Constitution.</li><li>• Establishment of ceiling provision in Equalization to limit cumulative overall growth of entitlements from a base year to growth in gross national product (later gross domestic product). The ceiling limited entitlements in four years: 1988–89, 1989–90, 1990–91 and 2000–01.</li><li>• Floor provision introduced to protect provinces from rapid major declines in entitlements.</li></ul>
1987–92	<ul style="list-style-type: none"><li>• Technical changes to several major bases, including the personal and corporate income tax bases and resource bases.</li></ul>
1994	<ul style="list-style-type: none"><li>• Implementation of the "generic solution"—inclusion at a 70-per-cent rate for tax bases concentrated in one province, i.e. where one province accounted for 70 per cent or more of the overall tax base.</li></ul>
1999	<ul style="list-style-type: none"><li>• 50 per cent of revenues from user fees excluded from Equalization. Technical changes to resource and non-resource bases.</li></ul>
2003	<ul style="list-style-type: none"><li>• Elimination of the ceiling provision effective 2002–03.</li></ul>
2004	<ul style="list-style-type: none"><li>• New framework and Expert Panel announced.</li></ul>





## Territorial Formula Financing

Territorial Formula Financing (TFF) is an annual, unconditional federal transfer to territorial governments designed to take into account the higher costs of providing public services in the territories. It is similar to Equalization in that its objective is to enable the territories to provide a range of public services reasonably comparable to those offered by provincial governments at reasonably comparable rates of taxation.

TFF is the principal federal transfer to the territories and represents the largest source of overall territorial revenues. In 2005–06, TFF grants accounted for roughly 81 per cent, 66 per cent and 61 per cent of overall revenues for the governments of Nunavut, the Northwest Territories and Yukon, respectively. Total TFF grants in 2005–06 were \$2.0 billion:

- \$799 million to Nunavut (\$26,738 per capita);
- \$714 million to the Northwest Territories (\$16,598 per capita); and
- \$487 million to Yukon (\$15,740 per capita).

Before TFF was introduced in 1985, the territories received funding from the federal government in much the same way as a federal department, based on a detailed, item-by-item review of projects, expenditure levels and expenditure priorities. TFF was introduced with the goal of furthering the evolution of territorial governments. TFF was based on multi-year federal-territorial agreements, which were generally renewed every five years. Starting in 2004–05, TFF levels have been legislated as part of the Federal-Provincial Fiscal Arrangements Act.

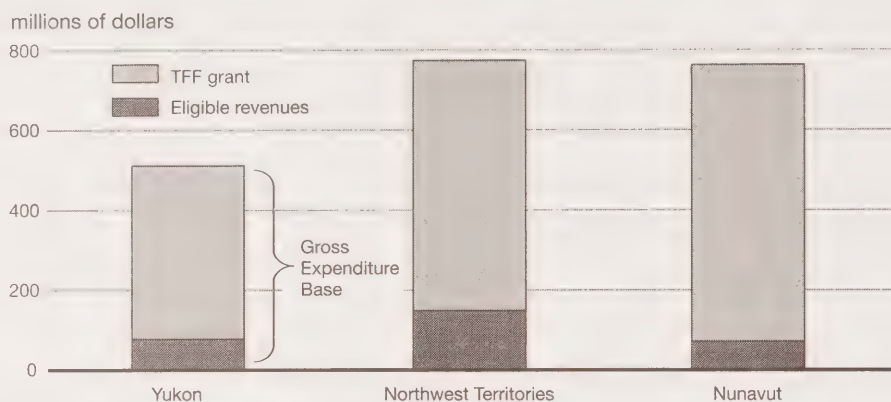
Until the introduction of a fixed framework in 2004, TFF was determined through a formula based on a “gap-filling” principle, taking into account the difference between the expenditure needs and the revenue means of territorial governments. This difference was calculated for each territory and determined the level of TFF grants.

Territorial expenditure needs were represented by the formula’s Gross Expenditure Base (GEB), a proxy for a territorial government’s “needs.” The initial GEB value in 1985 was based on each territorial government’s revenues in 1982–83. This benchmark GEB was then escalated annually to reflect the growth of provincial-local government expenditures over time. Revenue means, or eligible revenues, consisted of measuring territorial own-source revenues, including some transfers from the federal government.



Chart A3.3

## How TFF Worked Prior to the October 2004 Changes



## TFF Milestones: 1985 to 2004

- |      |  |
|------|--|
| 1985 | <ul style="list-style-type: none"><li>• TFF established.</li></ul>   |
| 1988 | <ul style="list-style-type: none"><li>• Gross domestic product ceiling was introduced to limit the annual level of the GEB escalator. This ceiling was subsequently eliminated effective 2002–03.</li></ul>  |
| 1990 | <ul style="list-style-type: none"><li>• Population adjustment factor was added to the GEB escalator to take into account the change in each territory's population growth relative to that of Canada as a whole.</li></ul>   |
| 1995 | <ul style="list-style-type: none"><li>• Economic Development Incentive was introduced to counter the anomalous outcomes of revenue adjustment in the formula.</li><li>• Territorial grant levels were frozen in 1995–96 at 1994–95 entitlement levels and each territory's GEB was reduced by 5 per cent in 1996–97.</li></ul> |
| 2003 | <ul style="list-style-type: none"><li>• Elimination of the ceiling provision effective 2002–03.</li></ul>  |
| 2004 | <ul style="list-style-type: none"><li>• New framework and Expert Panel announced.</li></ul>  |



## October 2004 Changes to Equalization and TFF

In October 2004, a new framework for Equalization and TFF was announced following two meetings of First Ministers, one on health care funding and one specifically devoted to Equalization and TFF.

1. **The 2004 renewal of the program was put on hold.** Following the usual five-year renewal process, Budget 2004 announced some major changes to Equalization for the 2004–05 to 2008–09 period, including the implementation of a three-year moving average of entitlements to address payment predictability and stability concerns, significant changes to the personal income tax and property tax bases, and improvements to various other bases. The legislation enacting these changes and the changes to TFF agreements were superseded by new legislation to enact the new framework,
2. **Normal formula-based calculations of provincial and territorial entitlements were suspended.** Provincial and territorial entitlement shares for 2004–05 were fixed on the basis of historical data. Interim formulas were subsequently used to allocate entitlements for 2005–06, with a similar approach to be used for 2006–07. (Budget 2006 announces the details of the new approach for 2006–07 payments to provinces and territories.)
3. **A new financial “framework” for Equalization and TFF was legislated.** Overall Equalization entitlements were increased by \$2.0 billion to \$10.9 billion for 2005–06, while TFF was increased by \$0.2 billion to \$2.0 billion. These amounts are to grow at 3.5 per cent per year in subsequent years, subject to a re-evaluation of funding levels and the funding growth rate at five-year intervals.
4. **A review of the Equalization program and TFF by an Expert Panel was announced.** The Expert Panel on Equalization and Territorial Formula Financing was asked to provide advice on: 1) the allocation of Equalization and TFF payments among provinces/territories from 2006–07 onwards; 2) how Equalization and TFF payments can be made more stable and predictable; 3) the information the federal government should take into account in reviewing the overall level of Equalization and TFF funding; 4) the appropriate treatment of natural resource revenues in Equalization and TFF; and 5) whether or not an independent body should be set up to provide ongoing advice on the allocation of Equalization and TFF entitlements.

Further information on the Panel can be found on its website at:  
<http://www.eqtff-pfft.ca/index.asp>.



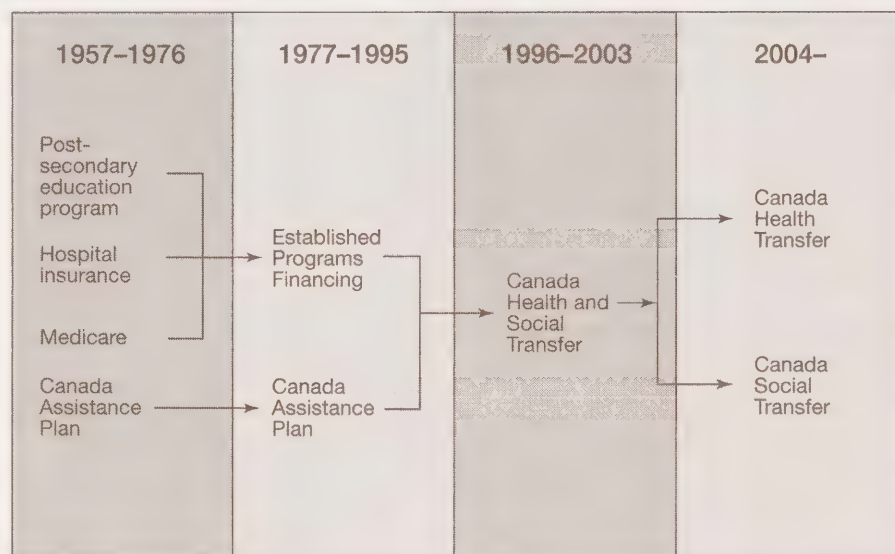
## Health and Social Transfers

The Government of Canada has used transfers to support provincial-territorial governments in providing health care, post-secondary education, social assistance and social services, and child care.

Federal support for health and social programs has evolved over time from cost-sharing arrangements (e.g. medicare and the Canada Assistance Plan), toward block transfers (e.g. the former Canada Health and Social Transfer).

Chart A3.4

### Evolution of Federal Transfers



Prior to 1977, the federal government provided support through cost-shared programs. Eligibility criteria were established under federal legislation to determine what expenditures would be included under a specific program—such as university grants. Typically the Government of Canada provided cash transfers equal to 50 per cent of eligible expenditures.



## Established Programs Financing and the Canada Assistance Plan

Established Program Financing (EPF) was created in 1977 when the Government of Canada merged the cost-sharing programs for health and post-secondary education into a single block transfer. Federal support through EPF comprised both cash and tax transfers, and provided separate notional allocations for health (68 per cent) and post-secondary education (32 per cent).

### What Is a Tax Transfer?

A federal tax transfer involves the federal government transferring some of its "tax room" to provincial and territorial governments. Specifically, a tax transfer occurs when, upon agreement, the federal government reduces its tax rates and provincial and territorial governments simultaneously raise their tax rates by an equivalent amount, with no overall change in the taxes paid by Canadians.

Since tax points are worth more in some provinces than in others, the federal government agreed to equalize the tax points on an ongoing basis. The result of this equalizing is that provinces receive higher payments, known as Associated Equalization, through the Equalization program.

A tax transfer has the same impact on federal and provincial/territorial budgets as a cash transfer. It represents forgone revenue to the federal government each and every year, and additional revenue to provincial and territorial governments.

Under EPF, a tax transfer of 13.5 personal income tax points and 1 corporate income tax point, an increase over the tax transfer provided for post-secondary education in the 1960s, was coordinated between the federal government and all provinces and territories.

After 1977, the only remaining major cost-shared program was the Canada Assistance Plan (CAP), which was created in 1966. Under CAP, the Government contributed 50 per cent of the eligible costs to support provincial/territorial social assistance and social services programs.



### Canada Health and Social Transfer

In 1996–97, EPF and CAP were replaced by a new block-fund transfer, the Canada Health and Social Transfer (CHST).

As part of this restructuring, federal cash transfers to provinces and territories for health and social programs were reduced by about \$6 billion, or 30 per cent, by the second year of the CHST.

The CHST maintained the cash and tax structure of EPF. Although not originally equal per capita, by 2001–02, CHST entitlements had evolved to become equal per capita for each province and territory.

As a block transfer, the CHST also provided provinces and territories with the flexibility to allocate federal support among health care, post-secondary education, and social assistance and social services, according to their respective priorities. There were no notional allocations for health and post-secondary education.

In the years following the creation of the CHST, the fiscal situation of the federal government improved rapidly and the federal government began to reinvest in transfers. CHST transfers were enhanced in the 1996, 1998, 1999 and 2000 budgets, from a floor of \$12.5 billion in 1997–98 to \$15.5 billion in 2000–01. Overall cash levels were fully restored in 2002–03 to the previous high point of EPF and CAP in 1994–95.

### Canada Health Transfer and Canada Social Transfer

Effective April 1, 2004, the Canada Health and Social Transfer was restructured into two new transfers:

- The Canada Health Transfer, a dedicated transfer in support of health.
- The Canada Social Transfer, a block transfer in support of post-secondary education, social assistance and social services, and child care.

The CHST was apportioned between the CHT and CST, with the percentage of cash and tax points allocated to each transfer reflecting provincial and territorial spending patterns among CHST-supported areas (62 per cent for the CHT and 38 per cent for the CST).

The CHT and CST maintained the cash and tax structure of the CHST and its equal per capita allocation formula.



### How the CHT and CST Work

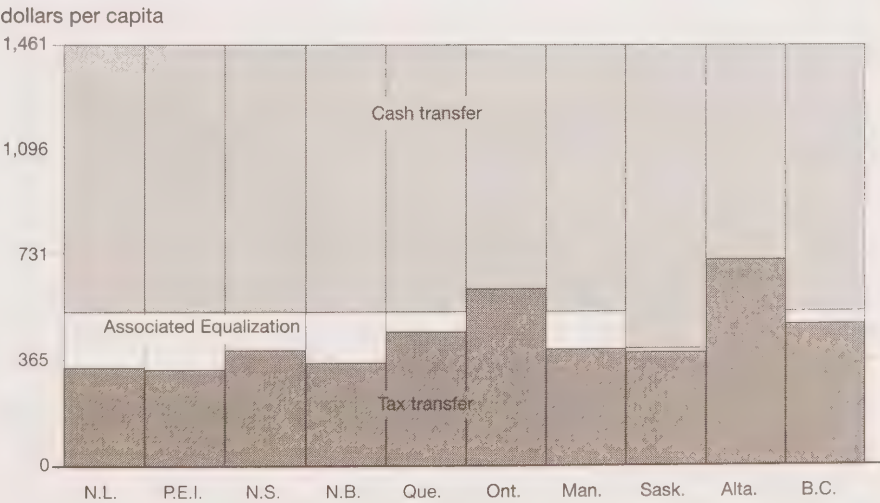
Total CHT/CST support is determined by adding the legislated cash levels to the equalized value of the tax transfer. This total is allocated among provinces and territories on an equal per capita basis to ensure equal support for all Canadians regardless of their province or territory of residence.

Individual provincial and territorial cash transfers are determined by subtracting the provincial/territorial value of the equalized tax transfer from the total provincial/territorial entitlement. In this way, provinces/territories with tax points that are worth more, such as Ontario and Alberta, receive less CHT/CST cash than other provinces/territories.

It is important to note that Equalization-receiving provinces receive higher Equalization payments because the tax points are equalized. This Associated Equalization is reflected in the determination of the cash transfer.

Note that Saskatchewan receives the largest per capita cash transfer due to the fact that in 2006–07 it only receives \$13 million in Equalization and its tax points are worth less than in other provinces.

### Equal Per Capita Support: \$1,461 Per Capita in 2006-07



The effect of this calculation is that the tax points are “super equalized” to ensure that total entitlements are equal per capita—a feature of the program since 1982.



CHT cash is established in legislation at \$20.1 billion in 2006–07, and is set to grow at 6 per cent annually until 2013–14, reflecting recent commitments made in support of the 10-Year Plan to Strengthen Health Care signed by First Ministers in September 2004. By the end of the legislated period, CHT cash transfers will be \$30.3 billion. The 10-Year Plan also provided targeted funding for medical equipment and long-term funding to reduce wait times with the creation of the Wait Times Reduction Transfer.

CST cash is set at \$8.5 billion in 2006–07 and will be \$8.8 billion in 2007–08 when the legislation expires.

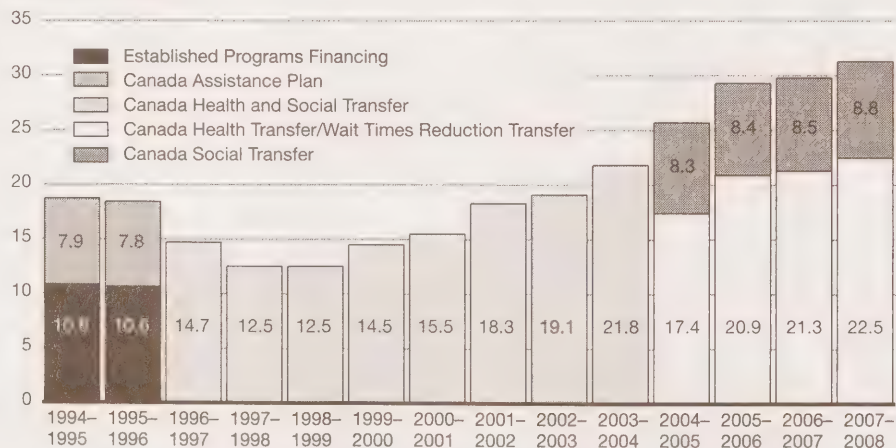
In 2006–07, provinces and territories will receive a total of \$47.5 billion in CHT and CST. Of this, \$18.9 billion will be in tax transfers and \$28.6 billion in cash transfers. Tax transfers provide a significant amount of support to the provinces and territories.

The chart below shows changes in health and social cash transfers from 1994–95 to 2007–08.

Chart A3.5

### Retrenchment and Growth in Health and Social Cash Transfers

billions of dollars



Source: Department of Finance Canada.



Table A3.1

Year		N.L.	P.E.I.	N.B.	N.S.	Que.	Ont.	Man.	Sask.	Alta.	B.C.	Y.T.	N.W.T.	Nun.	Canada
							(millions of dollars)								
1982-83	Cash	238	56	345	320	3,159	3,222	415	437	807	1,242	9	22	-	10,271
	Tax	113	24	169	139	1,289	1,919	206	179	672	635	5	11	-	5,362
	Total	351	80	514	459	4,449	5,141	621	616	1,478	1,877	14	33	-	15,633
1983-84	Cash	267	60	388	354	3,600	3,659	475	501	968	1,466	9	25	-	11,772
	Tax	117	25	175	144	1,324	2,026	213	177	638	624	5	12	-	5,480
	Total	385	85	563	498	4,924	5,684	688	678	1,606	2,099	14	37	-	17,252
1984-85	Cash	278	63	415	380	3,831	3,870	513	546	1,031	1,608	10	26	-	12,570
	Tax	127	28	192	157	1,441	2,269	234	184	671	649	6	14	-	5,971
	Total	405	91	607	537	5,272	6,139	747	729	1,702	2,256	16	40	-	18,541
1985-86	Cash	293	67	443	407	4,059	4,113	548	592	1,160	1,712	11	29	-	13,435
	Tax	139	31	211	172	1,581	2,556	258	190	688	690	6	14	-	6,536
	Total	432	98	654	580	5,640	6,669	806	781	1,848	2,401	18	43	-	19,971
1986-87	Cash	308	71	464	426	4,183	4,327	578	556	1,327	1,734	12	33	-	14,018
	Tax	151	34	232	189	1,741	2,870	285	269	670	750	7	14	-	7,213
	Total	459	104	697	615	5,925	7,197	863	825	1,996	2,483	19	47	-	21,231
1987-88	Cash	313	72	476	434	4,196	4,538	604	556	1,392	1,807	13	37	-	14,437
	Tax	168	38	260	211	1,954	3,286	320	301	707	843	7	16	-	8,111
	Total	481	110	736	645	6,150	7,824	924	857	2,099	2,650	20	52	-	22,548

Table A3.1

## Health and Social Transfer Entitlements (1982-83 to 2006-07) (cont'd)

Year	N.L.	P.E.I.	N.B.	N.S.	Que.	Ont.	Man.	Sask.	Alta.	B.C.	Y.T.	N.W.T.	Nun.	Canada
								(millions of dollars)						
1988-89	Cash	321	75	505	449	4,337	4,805	628	1,470	1,902	14	37	-	15,112
	Tax	180	41	280	227	2,107	3,673	344	756	943	8	18	-	8,899
	Total	502	116	785	676	6,444	8,479	972	2,225	2,846	22	55	-	24,011
1989-90	Cash	341	80	535	466	4,539	5,187	660	1,540	1,913	15	40	-	15,892
	Tax	194	44	302	244	2,281	4,050	370	829	1,090	9	20	-	9,777
	Total	535	124	837	710	6,820	9,237	1,030	2,369	3,003	24	60	-	25,669
1990-91	Cash	351	82	557	481	4,727	5,409	679	1,526	1,951	17	40	-	16,385
	Tax	197	45	311	251	2,360	4,077	377	906	1,176	10	24	-	10,078
	Total	549	128	868	732	7,087	9,485	1,057	2,432	3,126	26	64	-	26,463
1991-92	Cash	370	85	587	505	5,044	5,846	708	1,577	2,053	19	45	-	17,409
	Tax	194	44	307	251	2,370	4,003	373	915	1,187	10	24	-	10,014
	Total	564	129	894	756	7,414	9,849	1,080	2,492	3,240	29	69	-	27,424
1992-93	Cash	401	89	621	516	5,392	6,158	763	1,650	2,131	22	49	-	18,396
	Tax	191	43	302	249	2,339	3,927	366	906	1,218	10	23	-	9,904
	Total	591	132	923	766	7,731	10,085	1,128	2,556	3,349	32	71	-	28,300
1993-94	Cash	415	91	638	510	5,571	6,300	761	1,625	2,190	24	50	-	18,810
	Tax	193	44	308	250	2,396	4,020	372	958	1,271	10	24	-	10,181
	Total	608	135	946	760	7,967	10,320	1,133	2,583	3,461	34	75	-	28,991



Table A3.1  
Health and Social Transfer Entitlements (1982-83 to 2006-07) (cont'd)

Year	N.L.	P.E.I.	N.B.	N.S.	Que.	Ont.	Man.	Sask.	Alta.	B.C.	Y.T.	N.W.T.	Nun.	Canada
(millions of dollars)														
1994-95	Cash	423	89	633	501	5,550	6,338	745	630	1,504	2,235	23	53	- 18,726
	Tax	199	46	320	260	2,498	4,199	387	354	1,015	1,338	10	25	- 10,651
	<b>Total</b>	<b>623</b>	<b>135</b>	<b>953</b>	<b>760</b>	<b>8,048</b>	<b>10,537</b>	<b>1,131</b>	<b>985</b>	<b>2,519</b>	<b>3,574</b>	<b>33</b>	<b>79</b>	<b>- 29,377</b>
1995-96	Cash	414	88	624	493	5,481	6,215	737	632	1,485	2,235	23	55	- 18,483
	Tax	208	49	340	276	2,654	4,525	414	372	1,093	1,438	11	26	- 11,406
	<b>Total</b>	<b>623</b>	<b>138</b>	<b>964</b>	<b>769</b>	<b>8,136</b>	<b>10,740</b>	<b>1,151</b>	<b>1,003</b>	<b>2,577</b>	<b>3,673</b>	<b>34</b>	<b>81</b>	<b>- 29,889</b>
1996-97	Cash	345	71	508	401	4,512	4,787	598	500	1,112	1,843	18	47	- 14,742
	Tax	216	52	358	290	2,800	4,864	436	402	1,202	1,500	12	26	- 12,158
	<b>Total</b>	<b>561</b>	<b>124</b>	<b>866</b>	<b>691</b>	<b>7,311</b>	<b>9,651</b>	<b>1,035</b>	<b>902</b>	<b>2,313</b>	<b>3,343</b>	<b>30</b>	<b>73</b>	<b>- 26,900</b>
1997-98	Cash	283	61	432	338	3,900	3,885	507	430	878	1,724	19	44	- 12,500
	Tax	231	57	388	314	3,037	5,429	473	425	1,379	1,570	11	25	- 13,339
	<b>Total</b>	<b>513</b>	<b>118</b>	<b>820</b>	<b>652</b>	<b>6,936</b>	<b>9,314</b>	<b>979</b>	<b>855</b>	<b>2,257</b>	<b>3,293</b>	<b>30</b>	<b>70</b>	<b>- 25,839</b>
1998-99	Cash	276	61	432	338	3,863	3,810	507	433	894	1,827	19	41	- 12,500
	Tax	241	60	414	333	3,236	5,942	503	453	1,507	1,612	11	30	- 14,341
	<b>Total</b>	<b>517</b>	<b>122</b>	<b>845</b>	<b>671</b>	<b>7,099</b>	<b>9,751</b>	<b>1,010</b>	<b>885</b>	<b>2,401</b>	<b>3,440</b>	<b>30</b>	<b>70</b>	<b>- 26,841</b>
1999-00	Cash	289	71	488	388	3,983	4,715	587	513	1,311	2,105	20	9	22 14,500
	Tax	256	65	446	358	3,483	6,531	541	491	1,545	1,836	11	33	8 15,605
	<b>Total</b>	<b>545</b>	<b>136</b>	<b>934</b>	<b>746</b>	<b>7,467</b>	<b>11,246</b>	<b>1,128</b>	<b>1,004</b>	<b>2,856</b>	<b>3,941</b>	<b>31</b>	<b>42</b>	<b>29 30,105</b>
2000-01	Cash	296	74	512	409	4,179	5,135	623	529	1,323	2,373	20	4	22 15,500
	Tax	264	68	464	373	3,656	6,898	570	514	1,746	1,801	12	43	8 16,418
	<b>Total</b>	<b>560</b>	<b>142</b>	<b>976</b>	<b>782</b>	<b>7,835</b>	<b>12,033</b>	<b>1,193</b>	<b>1,044</b>	<b>3,069</b>	<b>4,175</b>	<b>32</b>	<b>47</b>	<b>31 31,918</b>





Table A3.2

**Equalization Entitlements (1982–83 to 2006–07)**

Year	N.L.	P.E.I.	N.S.	N.B.	Que.	Man.	Sask.	B.C.	Canada
(millions of dollars)									
1982–83	464	118	574	488	2,782	439	–	–	4,865
1983–84	539	125	605	517	2,977	466	–	–	5,229
1984–85	578	129	620	540	3,074	480	–	–	5,422
1985–86	653	134	596	604	2,728	427	–	–	5,143
1986–87	678	138	620	643	2,942	471	285	–	5,775
1987–88	807	163	734	724	3,151	727	299	–	6,605
1988–89	839	177	835	771	3,393	795	457	–	7,267
1989–90	895	192	885	884	3,355	958	639	–	7,808
1990–91	919	194	949	868	3,627	914	531	–	8,002
1991–92	874	186	850	967	3,464	853	479	–	7,673
1992–93	886	168	908	870	3,589	872	490	–	7,784
1993–94	900	175	889	835	3,878	901	486	–	8,063
1994–95	958	192	1,065	927	3,965	1,085	413	–	8,607
1995–96	932	192	1,137	876	4,307	1,051	264	–	8,759
1996–97	1,030	208	1,182	1,019	4,169	1,126	224	–	8,959
1997–98	1,093	238	1,302	1,112	4,745	1,053	196	–	9,738
1998–99	1,068	238	1,221	1,112	4,394	1,092	477	–	9,602
1999–00	1,169	255	1,290	1,183	5,280	1,219	379	125	10,900
2000–01	1,112	269	1,404	1,260	5,380	1,314	208	–	10,948
2001–02	1,055	256	1,315	1,202	4,679	1,362	200	240	10,310
2002–03	875	235	1,122	1,143	4,004	1,303	106	71	8,859
2003–04	766	232	1,130	1,142	3,764	1,336	–	320	8,690
2004–05 <sup>1</sup>	762	277	1,313	1,326	4,155	1,607	652	682	10,774
2005–06	861	277	1,344	1,348	4,798	1,601	82	590	10,900
2006–07 <sup>2</sup>	687	291	1,386	1,451	5,539	1,709	13	459	11,535

<sup>1</sup> Entitlements for 2004–05 exclude \$150 million in additional Equalization related to the 2004 renewal.

<sup>2</sup> Figures for 2006–07 are as proposed in Budget 2006 and include one-time adjustments.

Source: Department of Finance Canada, May 2006.





Table A3.3

**Territorial Formula Financing Entitlements (1982–83 to 2006–07)**

Year	Y.T.	N.W.T.	Nun.	Canada
(millions of dollars)				
1982–83	72	290	–	362
1983–84	103	350	–	452
1984–85	106	371	–	477
1985–86	151	454	–	606
1986–87	161	508	–	669
1987–88	170	560	–	730
1988–89	182	645	–	827
1989–90	193	704	–	897
1990–91	214	748	–	962
1991–92	223	782	–	1,005
1992–93	255	821	–	1,076
1993–94	289	861	–	1,150
1994–95	289	892	–	1,181
1995–96	291	906	–	1,197
1996–97	289	908	–	1,197
1997–98	307	921	–	1,229
1998–99	310	935	–	1,246
1999–00	319	493	520	1,333
2000–01	336	310	566	1,212
2001–02	359	546	613	1,518
2002–03	372	588	656	1,616
2003–04	435	626	692	1,754
2004–05	466	678	756	1,900
2005–06	487	714	799	2,000
2006–07 <sup>1</sup>	506	739	827	2,072

<sup>1</sup> Figures for 2006–07 are as proposed in Budget 2006 and include one-time adjustments.

Source: Department of Finance Canada, May 2006.











